FINANCIAL INSTITUTIONS INC
Form 10-K
March 07, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2010

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ________ to ________

Commission file number 000-26481

FINANCIAL INSTITUTIONS, INC.
(Exact name of registrant as specified in its charter)

NEW YORK	**16-0816610**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
220 LIBERTY STREET, WARSAW, NEW YORK	**14569**
(Address of principal executive offices)	(ZIP Code)

Registrant s telephone number, including area code: **(585) 786-1100**

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of exchange on which registered
Common stock, par value $.01 per share	**NASDAQ Global Select Market**

Securities registered under Section 12(g) of the Exchange Act: **NONE**

Indicate by check mark if the regsitrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the regsitrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The aggregate market value of common equity held by non-affiliates of the registrant, as computed by reference to the June 30, 2010 closing price reported by NASDAQ, was approximately $177,182,000.

As of March 1, 2011, there were issued and outstanding, exclusive of treasury shares, 10,979,715 shares of the registrant s common stock.

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PART I

FORWARD LOOKING INFORMATION

Statements in this Annual Report on Form 10-K that are based on other than historical data are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations or forecasts of future events and include, among others:

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the parent or FII) and its subsidiaries (collectively the Company, we, our, us);
- statements preceded by, followed by or that include the words may, could, should, would, believe, an estimate, expect, intend, plan, projects, or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management s views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this Annual Report on Form 10-K, including, but not limited to, those presented in the Management s Discussion and Analysis of Financial Condition and Results of Operation. Factors that might cause such differences include, but are not limited to:

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- We are subject to environmental liability risk associated with our lending activities;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- Recently enacted financial reform legislation will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new regulations that are expected to increase our costs of operations;
- As a participant in the Troubled Asset Relief Program (TARP), we are subject to certain restrictions on dividends, repurchases of common stock and executive compensation;
- New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition;
- If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation;
- We rely on other companies to provide key components of our business infrastructure;
- We may not be able to attract and retain skilled people;
- The potential for business interruption exists throughout our organization;
- We are subject to interest rate risk;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
- Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies;
- The soundness of other financial institutions could adversely affect us;
- We operate in a highly competitive industry and market area;
- Our market value could result in an impairment of goodwill;
- Liquidity is essential to our businesses;
- We may need to raise additional capital in the future and such capital may not be available when needed or at all;
- We rely on dividends from our subsidiaries for most of our revenue;
- The market price for our common stock varies;
- There may be future sales or other dilution of our equity, which may adversely affect the market price of our common stock;

- Our shares of common stock are equity and are subordinate to our existing and future indebtedness and our preferred stock, and are effectively subordinated to all the indebtedness and other non-common equity claims against our subsidiaries;
- We may not pay dividends on our common stock; and
- Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect.

We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors, in this Form 10-K.

Except as required by law, we do not undertake, and specifically disclaim any obligation to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

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ITEM 1. BUSINESS

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). Through its subsidiaries, including its wholly-owned, New York State chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. provides a broad array of deposit, lending and other financial services to retail, commercial, and municipal customers in Western and Central New York. All references in this Annual Report on Form 10-K to the parent company are to Financial Institutions, Inc. (FII). Unless otherwise indicated or unless the context requires otherwise, all references in this Annual Report on Form 10-K to the Company, we, our or us me Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, FSB or the Bank . The parent company is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and management. Our executive offices are located at 220 Liberty Street, Warsaw, New York.

We conduct business primarily through our banking subsidiary, Five Star Bank, which adopted its current name in 2005 when we merged three of our bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into our New York chartered bank subsidiary, First Tier Bank & Trust, which was renamed Five Star Bank. In addition, our business operations include a wholly-owned broker-dealer subsidiary, Five Star Investment Services, Inc. (FSIS).

OTHER INFORMATION

This Annual Report on Form 10-K, including the exhibits and schedules filed as part of the Annual Report on Form 10-K, may be inspected at the public reference facility maintained by the SEC at its public reference room at 100 F. Street, N.E., Room 1580, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at www.sec.gov.

We also make available, free of charge through our website at www.fiiwarsaw.com, all reports filed with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. Information available on our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

MARKET AREAS AND COMPETITION

We provide a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of over 50 offices and more than 70 ATMs in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties.

Our market area is economically diversified in that we serve both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with combined metropolitan area populations of over two million people. We anticipate increasing our presence in and around these metropolitan statistical areas in the coming years.

We face significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. Our competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial service companies. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies. We generally compete with other financial service providers on factors such as; level of customer service, responsiveness to customer needs, availability and pricing of products, and geographic location.

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LENDING ACTIVITIES

General

We offer a broad range of loans including commercial business and revolving lines of credit, commercial mortgages, equipment loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in our portfolio or sold to the secondary market with servicing rights retained.

We continually evaluate and update our lending policy. The key elements of our lending philosophy include the following:

- To ensure consistent underwriting, employees must share a common view of the risks inherent in lending activities as well as the standards to be applied in underwriting and managing credit risk;
- Pricing of credit products should be risk-based;
- The loan portfolio must be diversified to limit the potential impact of negative events; and
- Careful, timely exposure monitoring through dynamic use of our risk rating system is required to provide early warning and assure proactive management of potential problems.

Commercial Business and Commercial Mortgage Lending

We originate commercial business loans in our primary market areas and underwrite them based on the borrower s ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. Commercial business loans are offered to the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2010, $70.0 million, or 33%, of the aggregate commercial business loan portfolio were at fixed rates, while $141.0 million, or 67%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures and, to a smaller extent, agricultural real estate financing. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2010, $100.0 million, or 28%, of the aggregate commercial mortgage portfolio were at fixed rates, while $252.9 million, or 72%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Government Guarantee Programs

We participate in government loan guarantee programs offered by the Small Business Administration (SBA), U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2010, we had loans with an aggregate principal balance of $55.1 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while minimizing credit risk.

Residential Mortgage Lending

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, we have formally adopted the underwriting, appraisal, and servicing guidelines of the Federal Home Loan Mortgage Corporation (FHLMC) as part of our standard loan policy. As of December 31, 2010, the residential mortgage servicing portfolio totaled $328.9 million, the majority of which have been sold to FHLMC. As of December 31, 2010, our residential mortgage loan portfolio totaled $129.6 million, or

10% of our total loan portfolio. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer Lending

We offer a variety of loan products to our consumer customers, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2010, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

We indirectly originate, through franchised new car dealers, indirect consumer loans. The consumer indirect loan portfolio is primarily comprised of new and used automobile loans with terms that typically range from 36 to 84 months. We have expanded our relationships with franchised new car dealers in Western, Central and, most recently, into the Capital District of New York, and have selectively originated a mix of new and used automobile loans from those dealers. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011. As of December 31, 2010, the consumer indirect portfolio totaled $418.0 million, or 31% of our total loan portfolio.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer s home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2010, $97.2 million, or 47%, of the home equity portfolio was at fixed rates, while $111.2 million, or 53%, was at variable rates. The other consumer portfolio totaled $26.1 million as of December 31, 2010, all of which were fixed loans.

Credit Administration

Our loan policy establishes standardized underwriting guidelines, as well as the loan approval process and the committee structures necessary to facilitate and ensure the highest possible loan quality decision-making in a timely and businesslike manner. The policy establishes requirements for extending credit based on the size, risk rating and type of credit involved. The policy also sets limits on individual loan officer lending authority and various forms of joint lending authority, while designating which loans are required to be approved at the committee level.

Our credit objectives are as follows:

- Compete effectively and service the legitimate credit needs of our target market;
- Enhance our reputation for superior quality and timely delivery of products and services;
- Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;
- Focus on government guaranteed lending and establish a specialization in this area to meet the needs of the small businesses in our communities; and
- Comply with the relevant laws and regulations.

Our policy includes loan reviews, under the supervision of the Audit and Risk Oversight committees of the Board of Directors and directed by the Chief Risk Officer, in order to render an independent and objective evaluation of our asset quality and credit administration process.

Risk ratings are assigned to loans in the commercial business and commercial mortgage portfolios. The risk ratings are specifically used as follows:

- Profile the risk and exposure in the loan portfolio and identify developing trends and relative levels of risk;
- Identify deteriorating credits; and
- Reflect the probability that a given customer may default on its obligations.

Through the loan approval process, loan administration and loan review program, management seeks to continuously monitor our credit risk profile and assesses the overall quality of the loan portfolio and adequacy of the allowance for loan losses.

We have several procedures in place to assist in maintaining the overall quality of our loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans, including impaired loans, are generally classified as non-accruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as non-accruing if repayment in full of principal and/or interest is uncertain.

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Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. The allowance reflects management s estimate of the amount of probable loan losses in the portfolio, based on factors such as:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology in the estimation of the allowance for loan losses includes the following broad areas:

1. Impaired commercial business and commercial mortgage loans, generally in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).
2. The remaining portfolios of commercial business and commercial mortgage loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention, substandard and doubtful. Uncriticized loans, special mention loans, substandard loans and all doubtful loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with additional reserve amounts, if considered necessary, based upon qualitative factors. These qualitative factors include the levels and trends in delinquencies and non-accruing loans; trends in volume and terms of loans; effects of changes in lending policy; experience, ability, and depth of management; national and local economic conditions; concentrations of credit, interest rate environment; customer leverage; information (availability of timely financial information); and collateral values, among others.
3. The retail loan portfolio is segmented into the following types of loans: residential real estate, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer indirect and other consumer portfolios are based on vintage analyses performed with historical loss experience at 36 months and 24 months aging, respectively. The allocations on these portfolios are also supplemented with qualitative factors.

Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology described above. See also the section titled Allowance for Loan Losses Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

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INVESTMENT ACTIVITIES

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by the Asset-Liability Committee (ALCO), is responsible for investment portfolio decisions within the established policies.

Our investment securities strategy centers on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing credit risks, managing overall interest rate risks and maximizing portfolio yield. Our current policy generally limits security purchases to the following:

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g. the Government National Mortgage Association (GNMA)) and U.S. government-sponsored enterprise (GSE) securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), FHLMC, SBA and the Federal Farm Credit Bureau);
- Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs) and collateralized mortgage obligations (CMO) issued by GNMA, FNMA and FHLMC. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations;
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy un-rated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments in Small Business Investment Companies.

SOURCES OF FUNDS

Our primary sources of funds are deposits, borrowed funds and repurchase agreements, scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations.

We offer a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of noninterest-bearing demand, interest-bearing demand, savings, money market, club accounts and certificates of deposit. We also offer certificates of deposit with balances in excess of $100,000 to local municipalities, businesses, and individuals as well as Individual Retirement Accounts and other qualified plan accounts. The flow of deposits is influenced significantly by general economic conditions, prevailing interest rates and competition. Our deposits are obtained predominantly from the areas in which our branch offices are located. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. We have also utilized certificate of deposit sales in the national brokered market (brokered deposits) as a wholesale funding source; however, we had no brokered deposits at December 31, 2010. Our borrowings consist mainly of advances entered into with the FHLB, federal funds purchased and securities sold under repurchase agreements.

OPERATING SEGMENTS

Our primary operating segment is our subsidiary bank, FSB. Our brokerage subsidiary, FSIS, is also deemed an operating segment; however, it does not meet the applicable thresholds for separation.

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SUPERVISION AND REGULATION

The Company and our subsidiaries are subject to an extensive system of laws and regulations that are intended primarily for the protection of customers and depositors and not for the protection of security holders. These laws and regulations govern such areas as capital, permissible activities, allowance for loan losses, loans and investments, and rates of interest that can be charged on loans. Described below are elements of selected laws and regulations. The descriptions are not intended to be complete and are qualified in their entirety by reference to the full text of the statutes and regulations described.

Holding Company Regulation. As a bank holding company and financial holding company, we are subject to comprehensive regulation by the Board of Governors of the Federal Reserve System, frequently referred to as the Federal Reserve Board (FRB), under the Bank Holding Company Act, as amended by, among other laws, the Gramm-Leach-Bliley Act of 1999 (the Gramm-Leach-Bliley Act), and by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), enacted on July 21, 2010. We must file reports with the FRB and such additional information as the FRB may require, and our holding company and non-banking affiliates are subject to examination by the FRB. Under FRB policy, a bank holding company must serve as a source of strength for its subsidiary banks. Under this policy, the FRB may require, and has required in the past, a holding company to contribute additional capital to an undercapitalized subsidiary bank. The Bank Holding Company Act provides that a bank holding company must obtain FRB approval before:

- Acquiring directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares);
- Acquiring all or substantially all of the assets of another bank or bank holding company, or
- Merging or consolidating with another bank holding company.

The Bank Holding Company Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

The Gramm-Leach-Bliley Act amended portions of the Bank Holding Company Act to authorize bank holding companies, such as us, directly or through non-bank subsidiaries to engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake these activities, a bank holding company must become a financial holding company by submitting to the appropriate Federal Reserve Bank a declaration that the company elects to be a financial holding company and a certification that all of the depository institutions controlled by the company are well capitalized and well managed. During the second quarter of 2008, we received FRB approval for an election to reinstate our status as a financial holding company under the Gramm-Leach-Bliley Act.

Depository Institution Regulation. Our bank subsidiary is subject to regulation by the Federal Deposit Insurance Corporation (FDIC). This regulatory structure includes:

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;
- Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;

Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;

Rules restricting types and amounts of equity investments; and

Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

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Capital Adequacy Requirements. The FRB and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

The FRB s risk-based guidelines establish a two-tier capital framework. Tier 1 capital generally consists of common shareholders equity, retained earnings, a limited amount of qualifying perpetual preferred stock, qualifying trust preferred securities and non-controlling interests in the equity accounts of consolidated subsidiaries, less goodwill and certain intangibles. Tier 2 capital generally consists of certain hybrid capital instruments and perpetual debt, mandatory convertible debt securities and a limited amount of subordinated debt, qualifying preferred stock, loan loss allowance, and unrealized holding gains on certain equity securities. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. For bank holding companies, generally the minimum Tier 1 risk-based capital ratio is 4% and the minimum total risk-based capital ratio is 8%. Our Tier 1 and total risk-based capital ratios under these guidelines at December 31, 2010 were 12.34% and 13.60%, respectively.

The FRB s leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2010, we had a leverage ratio of 8.31%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 10, Regulatory Matters, of the notes to consolidated financial statements.

The federal regulatory authorities risk-based capital guidelines are based upon the 1988 capital accord (Basel I) of the Basel Committee on Banking Supervision (the Basel Committee). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country s supervisors in determining the supervisory policies and regulations to which they apply. Actions of the Committee have no direct effect on banks in participating countries. In 2004, the Basel Committee published a new capital accord (Basel II) to replace Basel I. Basel II provides two approaches for setting capital standards for credit risk an internal ratings-based approach tailored to individual institutions circumstances and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. Basel II also would set capital requirements for operational risk and refine the existing capital requirements for market risk exposures.

A final rule implementing the advanced approaches of Basel II in the United States would apply only to certain large or internationally active banking organizations, or core banks defined as those with consolidated total assets of $250 billion or more or consolidated on-balance sheet foreign exposures of $10 billion or more, became effective as of April 1, 2008. Certain other U.S. banking organizations would have the option to adopt the requirements of this rule. We are not required to comply with the advanced approaches of Basel II.

In July 2008, the agencies issued a proposed rule that would give banking organizations that do not use the advanced approaches the option to implement a new risk-based capital framework that generally parallels the relevant approaches under Basel II, but recognizes that U.S. markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. To date, no final rule has been adopted.

In 2009, the United States Department of Treasury (the Treasury) issued a policy statement (the Treasury Policy Statement) entitled Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms, which contemplates changes to the existing regulatory capital regime involving substantial revisions to major parts of the Basel I and Basel II capital frameworks and affecting all regulated banking organizations and other systemically important institutions. The Treasury Policy Statement calls for, among other things, higher and stronger capital requirements for all banking firms, with changes to the regulatory capital framework to be phased in over a period of several years.

On December 17, 2009, the Basel Committee issued a set of proposals (the 2009 Capital Proposals) that would significantly revise the definitions of Tier 1 capital and Tier 2 capital. Among other things, the 2009 Capital Proposals would re-emphasize that common equity is the predominant component of Tier 1 capital. Concurrently with the release of the 2009 Capital Proposals, the Basel Committee also released a set of proposals related to liquidity risk exposure (the 2009 Liquidity Proposals). The 2009 Liquidity Proposals include the implementation of (i) a liquidity coverage ratio or LCR, designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets sufficient to meet the bank s liquidity needs over a 30-day time horizon under an acute liquidity stress scenario and (ii) a net stable funding ratio or NSFR, designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon.

The Dodd-Frank Act includes certain provisions concerning the capital regulations of the U.S. banking regulators, which are often referred to as the Collins Amendment. These provisions are intended to subject bank holding companies to the same capital requirements as their bank subsidiaries and to eliminate or significantly reduce the use of hybrid capital instruments, especially trust preferred securities, as regulatory capital. Under the Collins Amendment, trust preferred securities issued by a company, such as our company, with total consolidated assets of less than $15 billion before May 19, 2010 and treated as regulatory capital are grandfathered, but any such securities issued later are not eligible as regulatory capital. The banking regulators must develop regulations setting minimum risk-based and leverage capital requirements for holding companies and banks on a consolidated basis that are no less stringent than the generally applicable requirements in effect for depository institutions under the prompt corrective action regulations discussed below. The banking regulators also must seek to make capital standards countercyclical so that the required levels of capital increase in times of economic expansion and decrease in times of economic contraction. The Dodd-Frank Act requires these new capital regulations to be adopted by the FRB in final form 18 months after its date of enactment (July 21, 2010). To date, no proposed regulations have been issued.

In December 2010 and January 2011, the Basel Committee published the final texts of reforms on capital and liquidity generally referred to as Basel III. Although Basel III is intended to be implemented by participating countries for large, internationally active banks, its provisions are likely to be considered by U.S. banking regulators in developing new regulations applicable to other banks in the United States, including Five Star Bank.

For banks in the United States, among the most significant provisions of Basel III concerning capital are the following:

- A minimum ratio of common equity to risk-weighted assets reaching 4.5%, plus an additional 2.5% as a capital conservation buffer, by 2019 after a phase-in period.
- A minimum ratio of Tier 1 capital to risk-weighted assets reaching 6.0% by 2019 after a phase-in period.
- A minimum ratio of total capital to risk-weighted assets, plus the additional 2.5% capital conservation buffer, reaching 10.5% by 2019 after a phase -in period.
- An additional countercyclical capital buffer to be imposed by applicable national banking regulators periodically at their discretion, with advance notice.
- Restrictions on capital distributions and discretionary bonuses applicable when capital ratios fall within the buffer zone.
- Deduction from common equity of deferred tax assets that depend on future profitability to be realized.
- Increased capital requirements for counterparty credit risk relating to OTC derivatives, repos and securities financing activities.
- For capital instruments issued on or after January 13, 2013 (other than common equity), a loss-absorbency requirement such that the instrument must be written off or converted to common equity if a trigger event occurs, either pursuant to applicable law or at the direction of the banking regulator. A trigger event is an event under which the banking entity would become nonviable without the write-off or conversion, or without an injection of capital from the public sector. The issuer must maintain authorization to issue the requisite shares of common equity if conversion were required.

The Basel III provisions on liquidity include complex criteria establishing the LCR and NSFR. The purpose of the LCR is to ensure that a bank maintains adequate unencumbered, high quality liquid assets to meet its liquidity needs for 30 days under a severe liquidity stress scenario. The purpose of the NSFR is to promote more medium and long-term funding of assets and activities, using a one-year horizon. Although Basel III is described as a final text, it is subject to the resolution of certain issues and to further guidance and modification, as well as to adoption by U.S. banking regulators, including decisions as to whether and to what extent it will apply to U.S. banks that are not large, internationally active banks.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within these categories. This act imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An undercapitalized bank must develop a capital restoration plan and its parent holding company must guarantee that bank s compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank s assets at the time it became undercapitalized or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent s general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet these standards.

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The various federal bank regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by the Federal Deposit Insurance Corporation Improvement Act, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. These regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive or order. An institution is adequately capitalized if it has a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a leverage ratio of at least 4% (3% in certain circumstances). An institution is undercapitalized if it has a Tier 1 risk-based capital ratio of less than 4%, a total risk-based capital ratio of less than 8% or a leverage ratio of less than 4% (3% in certain circumstances). An institution is significantly undercapitalized if it has a Tier 1 risk-based capital ratio of less than 3%, a total risk-based capital ratio of less than 6% or a leverage ratio of less than 3%. An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets. Generally, an institution may be reclassified in a lower capitalization category if it is determined that the institution is in an unsafe or unsound condition or engaged in an unsafe or unsound practice.

As of December 31, 2010, our subsidiary bank met the requirements to be classified as well-capitalized.

Dividends. The FRB policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, a bank that is classified under the prompt corrective action regulations as undercapitalized will be prohibited from paying any dividends.

On December 23, 2008, as part of the TARP Capital Purchase Program of the Treasury, we sold to the Treasury 7,503 shares of our fixed rate cumulative perpetual preferred stock, Series A preferred stock (Series A), having a liquidation preference amount of $5,000 per share, for a purchase price of $37.5 million in cash and issued to Treasury a ten-year warrant to purchase 378,175 shares of the Company s common stock at an exercise price of $14.88 per share (the Warrant).

We may redeem the Series A preferred stock at any time by repaying the Treasury, without penalty, subject to Treasury s consultation with our appropriate regulatory agency and approval. Additionally, upon redemption of the Series A preferred stock, the Warrant generally may be repurchased from the Treasury at its fair market value as agreed-upon by us and the Treasury. In February 2011, the Company repaid one-third or $12.5 million of its obligation.

The securities purchase agreement between us and the Treasury provides that prior to the earlier of (i) December 23, 2011 and (ii) the date on which all of the shares of the Series A preferred stock have been redeemed by us or transferred by the Treasury to third parties, we may not, without the consent of the Treasury, (a) pay a quarterly cash dividend on our common stock of more than $0.10 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock, preferred stock (other than the Series A preferred stock) or trust preferred securities. In addition, under the terms of the Series A preferred stock, we may not pay dividends on our common stock at any time we are in arrears on the dividends payable on the Series A preferred stock. Dividends on the Series A preferred stock are payable quarterly at a rate of 5% per annum for the first five years and a rate of 9% per annum thereafter if not redeemed prior to that time.

Our primary source for cash dividends is the dividends we receive from our subsidiary bank. Our bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Banking Department is required prior to paying a dividend if the dividends declared by the Bank exceed the sum of the Bank s net profits for that year and its retained net profits for the preceding two calendar years.

Federal Deposit Insurance Assessments. The Bank s deposits are insured to the maximum extent permitted by the Deposit Insurance Fund (DIF). Upon enactment of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, federal deposit insurance coverage levels under the DIF temporarily increased from $100,000 to $250,000 per deposit category, per depositor, per institution, through December 31, 2009. On May 20, 2009, the Helping Families

Save Their Homes Act extended the temporary increase through December 31, 2013. The Dodd-Frank Act permanently increases the maximum amount of deposit insurance to $250,000 per deposit category, per depositor, per institution retroactive to January 1, 2008, and noninterest-bearing transaction accounts have unlimited deposit insurance through December 31, 2013.

As the insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. The FDIC also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to initiate enforcement actions against banks. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged or is engaging in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or written agreement entered into with the FDIC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

The FDIC maintains the DIF by assessing depository institutions an insurance premium on a quarterly basis under a risk-based assessment system. The amount of the assessment is a function of the institution s risk category, of which there are four, and assessment base. An institution s risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution s assessment rate. The assessment rate for risk categories are calculated according to a formula, which relies on supervisory ratings and either certain financial ratios or long-term debt ratings. An insured bank s assessment base is currently determined by its level of deposits. Because the system is risk-based, it allows banks to pay lower assessments to the FDIC as their capital level and supervisory ratings improve. By the same token, if these indicators deteriorate, the institution will have to pay higher assessments to the FDIC.

Under the Federal Deposit Insurance Act, the FDIC Board has the authority to set the annual assessment rate range for the various risk categories within certain regulatory limits and to impose special assessments upon insured depository institutions when deemed necessary by the FDIC s Board. As part of the Deposit Insurance Fund Restoration Plan adopted by the FDIC in October 2008, on February 27, 2009, the FDIC adopted the final rule modifying the risk-based assessment system, which set initial base assessment rates between 12 and 45 basis points, beginning April 1, 2009. The FDIC imposed an emergency special assessment on June 30, 2009, which totaled $923 thousand for our Bank. In addition, in September 2009, the FDIC extended the Restoration Plan period to eight years. In November 2009, the FDIC adopted a final rule requiring prepayment of 13 quarters of FDIC premiums. The Bank s required prepayment amounted to $9.9 million and was collected in December 2009.

In October 2010, the FDIC adopted a new Restoration Plan for the DIF to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. Under the Restoration Plan, the FDIC did not institute the uniform three-basis point increase in assessment rates scheduled to take place on January 1, 2011 and maintained the current schedule of assessment rates for all depository institutions. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking, if required.

In November 2010, the FDIC issued a notice of proposed rulemaking to change the deposit insurance assessment base from total domestic deposits to average total assets minus average tangible equity, as required by the Dodd-Frank Act, effective April 1, 2011. The FDIC also issued a notice of proposed rulemaking to revise the deposit insurance assessment system for large institutions. The FDIC proposed to create a two tier system one for most large institutions that have more than $10 billion in assets, and another for highly complex institutions that have over $50 billion in assets and are fully owned by a parent with over $500 billion in assets. These proposals did not apply to us or the Bank.

On February 9, 2011, the FDIC adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act. The final rule sets the deposit insurance assessment base as average consolidated total assets minus average tangible equity. It also sets a new assessment rate schedule which reflects assessment rate adjustments including potentially reduced rates tied to unsecured debt and potentially increased rates for brokered deposits. The final rule generally becomes effective on April 1, 2011. Under the new rule, our FDIC insurance premiums are expected to decline in 2011. However, there can be no assurances that such premium reductions will be realized in 2011.

Transactions with Affiliates. FII and FSB are affiliates within the meaning of the Federal Reserve Act. The Federal Reserve Act imposes limitations on a bank with respect to extensions of credit to, investments in, and certain other transactions with, its parent bank holding company and the holding company s other subsidiaries. Furthermore, bank loans and extensions of credit to affiliates also are subject to various collateral requirements.

Community Reinvestment Act. Under the Community Reinvestment Act, every FDIC-insured institution is obligated, consistent with safe and sound banking practices, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The Community Reinvestment Act requires the appropriate federal banking regulator, in connection with the examination of an insured institution, to assess the institution s record of meeting the credit needs of its community and to consider this record in its evaluation of certain applications, such as a merger or the establishment of a branch. An unsatisfactory rating may be used as the basis for the denial of an application and will prevent a bank holding company of the institution from making an election to become a financial holding company.

As of its last Community Reinvestment Act examination, Five Star Bank received a rating of outstanding.

Interstate Banking and Branching. The FRB may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the bank holding company s home state, without regard to whether the transaction is prohibited by the laws of any state. The FRB may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the law of the target bank s home state. The FRB also may not approve an application if the bank holding company (and its bank affiliates) controls or would control more than ten percent of the insured deposits in the U.S. or, generally, 30% or more of the deposits in the target bank s home state or in any state in which the target bank maintains a branch. Individual states may waive the 30% statewide concentration limit. Each state may limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company to the extent the limitation does not discriminate against out-of-state banks or bank holding companies.

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The federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether these transactions are prohibited by the law of any state, unless the home state of one of the banks opted out of interstate mergers prior to June 1, 1997. Interstate acquisitions of branches are permitted only if the law of the state in which the branch is located permits these acquisitions. Interstate mergers and branch acquisitions are subject to the nationwide and statewide-insured deposit concentration limits described above.

Privacy Rules. Federal banking regulators, as required under the Gramm-Leach-Bliley Act, have adopted rules limiting the ability of banks and other financial institutions to disclose nonpublic information about consumers to non-affiliated third parties. The rules require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to non-affiliated third parties. The privacy provisions of the Gramm-Leach-Bliley Act affect how consumer information is transmitted through diversified financial services companies and conveyed to outside vendors.

International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. The President signed the USA Patriot Act of 2001 into law in October 2001. This act contains the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the IMLAFA). The IMLAFA substantially broadens existing anti-money laundering legislation and the extraterritorial jurisdiction of the U.S., imposes new compliance and due diligence obligations, creates new crimes and penalties, compels the production of documents located both inside and outside the U.S., including those of foreign institutions that have a correspondent relationship in the U.S., and clarifies the safe harbor from civil liability to customers. The Treasury Department has issued a number of regulations implementing the USA Patriot Act that apply certain of its requirements to financial institutions such as our banking and broker-dealer subsidiaries. The regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing. The increased obligations of financial institutions, including us, to identify their customers, watch for and report suspicious transactions, respond to requests for information by regulatory authorities and law enforcement agencies, and share information with other financial institutions, requires the implementation and maintenance of internal procedures, practices and controls which have increased, and may continue to increase, our costs and may subject us to liability.

As noted above, enforcement and compliance-related activity by government agencies has increased. Money laundering and anti-terrorism compliance is among the areas receiving a high level of focus in the present environment.

Regulatory Reform. On July 21 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act (as amended) implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- Centralize responsibility for consumer financial protection by creating a new agency, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and certain others, including the examination and enforcement powers with respect to any bank with more than $10 billion in assets.
- Require new capital rules and apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies.
- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated average assets less tangible capital.
- Increase the minimum ratio of net worth to insured deposits of the Deposit Insurance Fund from 1.15% to 1.35% and require the FDIC, in setting assessments, to offset the effect of the increase on institutions with assets of less than $10 billion. As a result, this increase is generally expected to impose more deposit insurance cost on institutions with assets of $10 billion or more.
- Provide for new disclosure and other requirements relating to executive compensation and corporate governance, including guidelines or regulations on incentive-based compensation and a prohibition on compensation arrangements that encourage inappropriate risks or that could provide excessive compensation.
- Make permanent the $250 thousand limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts and IOLTA accounts at

all insured depository institutions.
Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Allow de novo interstate branching by banks.

Increase the authority of the FRB to examine the Company and its non-bank subsidiary.
Require all bank holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

Restrict proprietary trading by banks, bank holding companies and others, and their acquisition and retention of ownership interests in and sponsorship of hedge funds and private equity funds. This restriction is commonly referred to as the Volcker Rule. There is an exception in the Volcker Rule to allow a bank to organize and offer hedge funds and private equity funds to customers if certain conditions are met. These conditions include, among others, requirements that the bank provides *bona fide* investment advisory services; the funds are organized only in connection with such services and to customers of such services; the bank does not have more than a *de minimis* interest in the funds, limited to a 3% ownership interest in any single fund and an aggregated investment in all funds of 3% of Tier 1 capital; the bank does not guarantee the obligations or performance of the funds; and no director or employee of the bank has an ownership interest in the fund unless he or she provides services directly to the funds. Further details on the scope of the Volcker Rule and its exceptions are expected to be defined in regulations due to be issued later in 2011.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and the financial services industry more generally. Provisions in the legislation that affect deposit insurance assessments, and payment of interest on demand deposits could increase the costs associated with deposits. Provisions in the legislation that require revisions to the capital requirements of the Company and Five Star Bank could require the Company and the Bank to seek additional sources of capital in the future.

TARP-Related Compensation and Corporate Governance Requirements. The Emergency Economic Stabilization Act of 2008 (EESA) was signed into law on October 3, 2008 and authorized the Treasury to provide funds to be used to restore liquidity and stability to the U.S. financial system pursuant to the TARP. Under the authority of EESA, Treasury instituted the TARP Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. As noted above, on December 23, 2008, we participated in this program by issuing 7,503 shares of our Series A preferred stock to the Treasury for a purchase price of $37.5 million in cash and issued the Warrant to the Treasury. In February 2011, the Company repaid one-third or $12.5 million of its obligation.

In addition to the restrictions on the Company s ability to pay dividends on and repurchase its stock, as described above under Dividends, participation in the TARP Capital Purchase Program also includes certain requirements and restrictions regarding compensation that were expanded significantly by the American Recovery and Reinvestment Act of 2009 (ARRA), as implemented by the Treasury s Interim Final Rule on TARP Standards for Compensation and Corporate Governance. These requirements and restrictions include, among others, the following: (i) a prohibition on paying or accruing bonuses, retention awards and incentive compensation, other than qualifying long-term restricted stock or pursuant to certain preexisting employment contracts, to our five most highly-compensated employees; (ii) a general prohibition on providing severance benefits, or other benefits due to a change in control of the Company, to our senior executive officers (SEOs) and next five most highly compensated employees; (iii) a requirement to make subject to clawback any bonus, retention award, or incentive compensation paid to any of the SEOs and any of the next twenty most highly compensated employees if such compensation was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria; (iv) a requirement to establish a policy on luxury or excessive expenditures; (v) a requirement to annually provide shareholders with a non-binding advisory say on pay vote on executive compensation; (vi) a prohibition on deducting more than $500,000 in annual compensation, including performance-based compensation, to the executives covered under Internal Revenue Code Section 162(m); (vii) a requirement that the compensation committee of the board of directors evaluate and review on a semi-annual basis the risks involved in employee compensation plans; and (viii) a prohibition on providing tax gross-ups to our SEOs and the next 20 most highly compensated employees. These requirements and restrictions will remain applicable to us until we have redeemed the Series A preferred stock in full.

Incentive Compensation. On October 22, 2009, the Federal Reserve issued a comprehensive proposal on incentive compensation policies (the Incentive Compensation Proposal) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The Incentive Compensation Proposal, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization s board of directors. Banking organizations are instructed to begin an immediate review of their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. Where there are deficiencies in the incentive compensation arrangements, they must be immediately addressed.

Additionally, the Incentive Compensation Proposal will require the Federal Reserve to review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as us, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization s supervisory ratings, which can affect the organization s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

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The scope and content of the U.S. banking regulators policies on executive compensation are continuing to develop and are likely to continue evolving in the near future. It cannot be determined at this time whether compliance with such policies will adversely affect our ability to hire, retain and motivate its key employees.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting measures for companies that have securities registered under the Exchange Act, including publicly-held bank holding companies such as Financial Institutions. Specifically, the Sarbanes-Oxley Act of 2002 and the various regulations promulgated thereunder, established, among other things: (i) requirements for audit committees, including independence, expertise, and responsibilities; (ii) responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of the reporting company s securities by the Chief Executive Officer and Chief Financial Officer in the twelve-month period following the initial publication of any financial statements that later require restatement; (iv) the creation of an independent accounting oversight board; (v) standards for auditors and regulation of audits, including independence provisions that restrict non-audit services that accountants may provide to their audit clients; (vi) disclosure and reporting obligations for the reporting company and their directors and executive officers, including accelerated reporting of stock transactions and a prohibition on trading during pension blackout periods; (vii) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; and (viii) a range of civil and criminal penalties for fraud and other violations of the securities laws.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act and the Real Estate Settlement Procedures Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations. The Check Clearing for the 21st Century Act (the Check 21 Act), which became effective on October 28, 2004, creates a new negotiable instrument, called a substitute check , which banks are required to accept as the legal equivalent of a paper check if it meets the requirements of the Check 21 Act. The Check 21 Act is designed to facilitate check truncation, to foster innovation in the check payment system, and to improve the payment system by shortening processing times and reducing the volume of paper checks.

Other Future Legislation and Changes in Regulations. In addition to the specific proposals described above, from time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or any its subsidiaries could have a material effect on our business.

Impact of Inflation and Changing Prices

Our financial statements included herein have been prepared in accordance with GAAP, which requires us to measure financial position and operating results principally using historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. In our view, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are generally influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude. Interest rates are sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

Regulatory and Economic Policies

Our business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities. The FRB regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy available to the FRB are (i) conducting open market operations in U.S. government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason, the policies of the FRB could have a material effect on our earnings.

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EMPLOYEES

At December 31, 2010, we had 616 employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees are good.

EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth current information regarding our executive officers and certain other significant employees (ages are as of May 4, 2011, the date of the 2011 Annual Meeting of Shareholders).

Name	Age	Started In	Positions/Offices
Peter G. Humphrey	56	1977	President and Chief Executive Officer of the Company and the Bank since 1994.
Karl F. Krebs	55	2009	Executive Vice President and Chief Financial Officer of the Company and the Bank since 2009. Senior Financial Specialist at West Valley Environmental Services, LLC prior to joining FII in 2009. President of Robar General Funding Corp. from 2006 to 2008. Senior Vice President and Line-of-Business Finance Director at Five Star Bank from 2005 to 2006 and Senior Vice President at Wyoming County Bank from 2004 to 2005.
Rita M. Bartol	50	2010	Senior Vice President and Director of Human Resources of the Company and the Bank since late 2010. Senior Vice President and Director of Human Resources at Cardinal Financial Corporation in 2010 and Vice President and Director of Human Resources at Union Bankshares Corporation from 2006 to 2010. Vice President and Human Resources and Organizational Development Manager at M & T Bank Corporation from 1998 to 2005.
Martin K. Birmingham	44	2005	Executive Vice President and Regional President / Commercial Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005.
George D. Hagi	58	2006	Executive Vice President and Chief Risk Officer of the Company and the Bank since 2006. Senior Vice President and Director of Risk Management at First National Bankshares of Florida and FNB Corp. from 1997 to 2005.
Richard J. Harrison	65	2003	Executive Vice President and Senior Retail Lending Administrator of the Bank since 2009. Senior Vice President and Senior Retail Lending Administrator of the Bank since 2003. Executive Vice President and Chief Credit Officer at Savings Bank of the Finger Lakes from 2000 to 2003.
Kevin B. Klotzbach	58	2001	Senior Vice President and Treasurer of the Bank since 2001.
R. Mitchell McLaughlin	53	1981	

			Executive Vice President and Chief Information Officer of the Bank since 2009. Senior Vice President and Chief Information Officer of the Bank since 2006.
John L. Rizzo	61	2010	Senior Vice President and Corporate Secretary of the Company and the Bank since 2010. Counsel (in-house) for the Company and the Bank since 2007. Genesee County (New York) Attorney from 1976 to 2010.
John J. Witkowski	48	2005	Executive Vice President and Regional President / Retail Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Vice President and Director of Sales for Business Banking / Client Development Group at Bank of America from 1993 to 2005.

ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference herein. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

CREDIT RISKS

If we experience greater credit losses than anticipated, earnings may be adversely impacted.

As a lender, we are exposed to the risk that customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. Credit losses are inherent in the business of making loans and could have a material adverse impact on our results of operations.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral, and we provide an allowance for estimated loan losses based on a number of factors. We believe that the allowance for loan losses is adequate. However, if our assumptions or judgments are wrong, the allowance for loan losses may not be sufficient to cover the actual credit losses. We may have to increase the allowance in the future in response to the request of one of our primary banking regulators, to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio. The actual amount of future provisions for credit losses may vary from the amount of past provisions.

Geographic concentration may unfavorably impact our operations.

Substantially all of our business and operations are concentrated in the Western and Central New York region. As a result of this geographic concentration, our results depend largely on economic conditions in these and surrounding areas. Deterioration in economic conditions in our market could:

- increase loan delinquencies;
- increase problem assets and foreclosures;
- increase claims and lawsuits;
- decrease the demand for our products and services; and
- decrease the value of collateral for loans, especially real estate, in turn reducing customers borrowing power, the value of assets associated with non-performing loans and collateral coverage.

Generally, we make loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market areas could reduce our growth rate, affect our borrowers ability to repay their loans and, consequently, adversely affect our business, financial condition and performance. For example, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real estate values in our market area could leave many of these loans inadequately collateralized. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on our results of operations could be materially adverse.

We depend on the accuracy and completeness of information about or from customers and counterparties.

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. We may also rely on representations of those customers, counterparties, or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports, or other financial information could cause us to enter into unfavorable transactions, which could have a material adverse effect on our financial condition and results of operations.

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We are subject to environmental liability risk associated with our lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

REGULATORY/LEGAL/COMPLIANCE RISKS

We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices.

We are subject to extensive supervision, regulation and examination. This regulatory structure gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies to address not only compliance with applicable laws and regulations (including laws and regulations governing consumer credit, and anti-money laundering and anti-terrorism laws), but also capital adequacy, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. As part of this regulatory structure, we are subject to policies and other guidance developed by the regulatory agencies with respect to capital levels, the timing and amount of dividend payments, the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Under this structure the regulatory agencies have broad discretion to impose restrictions and limitations on our operations if they determine, among other things, that our operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

This supervisory framework could materially impact the conduct, growth and profitability of our operations. Any failure on our part to comply with current laws, regulations, other regulatory requirements or safe and sound banking practices or concerns about our financial condition, or any related regulatory sanctions or adverse actions against us, could increase our costs or restrict our ability to expand our business and result in damage to our reputation.

Recently enacted financial reform legislation will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new regulations that are expected to increase our costs of operations.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. This new law will significantly change the current bank regulatory structure and affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Among the many requirements in the Dodd-Frank Act for new banking regulations is a requirement for new capital regulations to be adopted within 18 months. These regulations must be at least as stringent as, and may call for higher levels of capital, than current regulations. Generally, trust preferred securities will no longer be eligible as Tier 1 capital, but our currently outstanding trust preferred securities will be grandfathered and our currently outstanding TARP preferred securities will continue to qualify as Tier 1 capital.

Certain provisions of the Dodd-Frank Act are expected to have a near-term impact on us. For example, one year after the date of its enactment, the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts and interest on lawyers trust accounts have unlimited deposit insurance through December 31, 2013.

The Dodd-Frank Act creates a new Bureau of Consumer Financial Protection with broad powers to supervise and enforce consumer protection laws. The Bureau will have broad rule-making authority for a wide range of consumer protection laws that apply to all banks, including the authority to prohibit unfair, deceptive or abusive acts and practices.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. However, compliance with this new law and its implementing regulations will result in additional operating costs that could have a material adverse effect on our financial condition and results of operations.

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As a participant in TARP, we are subject to certain restrictions on dividends, repurchases of common stock and executive compensation.

We are subject to restrictions on dividends, repurchases of common stock, and executive compensation as a TARP participant. Compliance with these restrictions and other restrictions may increase our costs, impact our ability to retain executive officers and limit our ability to pursue business opportunities. Additionally, any reduction of, or the elimination of, our common stock dividend in the future could adversely affect the market price of our common stock. The current restrictions, as well as any possible future restrictions, associated with participation in TARP could have a material adverse impact on our business, financial condition, or results of operations.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company s stockholders. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in the section captioned Supervision and Regulation included in Part I, Item 1, Business . These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

Proposed changes in New York State banking regulations could adversely affect us.

New York Governor Andrew Cuomo proposed merging the State Departments of Banking, Insurance and Consumer Protection into a single Department of Financial Regulation, or DFR. The bill provides that the Superintendent of the DFR may, beginning April 1, 2012, assess expenses in such proportion as he or she deems just and reasonable against banks and insurers. The bill also establishes a special account called the consumer protection account, which will consist of fees and penalties received by the department of state and DFR, as well as other monies received in the form of penalties. These monies will be available to the DFR to pay for costs related to its consumer and investor protection activities. If the consumer protection account is insufficient to cover those costs, the balance would be recoverable through assessments against the industry.

The bill makes New York s wild card authority (that was set to expire September 10, 2011) permanent. Under this authority, the Banking Board has the power to grant to New York chartered banking organizations, as well as licensed foreign bank branches and agencies, powers possessed by a counterpart federally-chartered banking institution.

If this bill is adopted as proposed, it could adversely affect us.

OPERATIONAL RISKS

If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation.

As part of our business, we collect, process and retain sensitive and confidential client and customer information on our behalf and on behalf of other third parties. Customer data also may be stored on systems of third-party service providers and merchants that may have inadequate security systems. Third-party carriers regularly transport customer data, and may lose sensitive customer information. Unauthorized access to our networks or any of our other information systems potentially could jeopardize the security of confidential information stored in our computer systems or transmitted by our customers or others. If our security systems or those of merchants, processors or other third-party service providers are compromised such that this confidential information is disclosed to unauthorized parties, we may be subject to liability. For example, in the event of a security breach, we may incur losses related to fraudulent use of debit cards issued by us as well as the operational costs associated with reissuing cards. Although we take preventive measures to address these factors, such measures are costly and may become more costly in the future. Moreover, these measures may not protect us from liability, which may not be adequately covered by insurance, or from damage to our reputation.

We rely on other companies to provide key components of our business infrastructure.

Third party vendors provide key components of our business infrastructure such as internet connections, network access and core application processing. While we have selected these third party vendors carefully, we do not control their actions. Any problems caused by these third parties, including as a result of their not providing us their services for any reason or their performing their services poorly, could adversely affect our ability to deliver products and services to our customers or otherwise conduct our business efficiently and effectively. Replacing these third party vendors could also entail significant delay and expense.

We may not be able to attract and retain skilled people.

Our success depends, in large part, on our ability to attract and retain skilled people. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to hire sufficiently skilled people or to retain them. Further, the rural location of our principal executive offices and many of our bank branches make it difficult for us to attract skilled people to such locations. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our markets, years of industry experience, and the difficulty of promptly finding qualified replacement personnel.

The potential for business interruption exists throughout our organization.

Integral to our performance is the continued efficacy of our technical systems, operational infrastructure, relationships with third parties and the vast array of associates and key executives in our day-to-day and ongoing operations. Failure by any or all of these resources subjects us to risks that may vary in size, scale and scope. This includes, but is not limited to, operational or technical failures, ineffectiveness or exposure due to interruption in third party support as expected, as well as the loss of key individuals or failure on the part of key individuals to perform properly. Although management has established policies and procedures, including implementation and testing of a comprehensive contingency plan, to address such failures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

EXTERNAL RISKS

We are subject to interest rate risk.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities; and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

Our business may be adversely affected by conditions in the financial markets and economic conditions generally.

From December 2007 through June 2009, the U.S. economy was in recession. Business activity across a wide range of industries and regions in the U. S. was greatly reduced. Although economic conditions have begun to improve, certain sectors, such as real estate, remain weak and unemployment remains high. Local governments and many businesses are still in serious difficulty due to lower consumer spending and reduced tax collections.

Market conditions also led to the failure or merger of several prominent financial institutions and numerous regional and community-based financial institutions. These failures, as well as projected future failures, have had a significant negative impact on the capitalization level of the deposit insurance fund of the FDIC, which, in turn, has led to past increases in deposit insurance premiums paid by financial institutions.

Our financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services we offer, is highly dependent on the business environment in the markets where we operate, in the State of New York and in the United States as a whole. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment, natural disasters; or a combination of these or other factors.

Approximately 20% of our investment securities portfolio at December 31, 2010 is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from regular federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers. The concerns facing the State of New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York s debt obligations. However, the fallout from continued budgetary concerns and a possible ratings downgrade could adversely affect the value of New York s obligations and those of its political subdivisions, agencies and instrumentalities.

Overall, during 2010, the business environment has been adverse for many households and businesses in the United States and worldwide. While economic conditions in the State of New York, the United States and worldwide have begun to improve, there can be no assurance that this improvement will continue. Such conditions could adversely affect our financial condition and results of operations.

Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.

The policies of the Federal Reserve impact us significantly. The Federal Reserve regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits and can also affect the value of financial instruments we hold. Those policies determine to a significant extent our cost of funds for lending and investing. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve could reduce the demand for a borrower s products and services. This could adversely affect the borrower s earnings and ability to repay its loan, which could have a material adverse effect on our financial condition and results of operation.

The soundness of other financial institutions could adversely affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse effect on our financial condition and results of operations.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional and internet banks within the various markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Our ability to compete successfully depends on a number of factors, including, among other things:

- the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and

industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Our market value could result in an impairment of goodwill.

Our goodwill is evaluated for impairment on an annual basis or when triggering events or circumstances indicate impairment may exist. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates could result in impairment of goodwill. At December 31, 2010, we had goodwill of $37.4 million, representing approximately 18% of shareholders equity. If impairment of goodwill was determined to exist, we would be required to write down our goodwill as a charge to earnings, which could have a material adverse impact on our results of operations or financial condition. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 6, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

LIQUIDITY RISKS

Liquidity is essential to our businesses.

Our liquidity could be impaired by an inability to access the capital markets or unforeseen outflows of cash. This situation may arise due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or us. Our efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated reductions in our liquidity. In such events, our cost of funds may increase, thereby reducing our net interest revenue, or we may need to sell a portion of our investment and/or loan portfolio, which, depending upon market conditions, could result in our realizing a loss.

We may need to raise additional capital in the future and such capital may not be available when needed or at all.

We may need to raise additional capital in the future to provide sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance.

In addition, we are highly regulated, and our regulators could require us to raise additional common equity in the future. Both we and our regulators perform a variety of analyses of our assets, including the preparation of stress case scenarios, and as a result of those assessments we could determine, or our regulators could require us, to raise additional capital.

We cannot assure that such capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of the Bank or counterparties participating in the capital markets, or a downgrade of our debt rating, may adversely affect our capital costs and ability to raise capital and, in turn, our liquidity. An inability to raise additional capital on acceptable terms when needed could have a material adverse impact on our business, financial condition, results of operations or liquidity.

We rely on dividends from our subsidiaries for most of our revenue.

We are a separate and distinct legal entity from our subsidiaries. A substantial portion of our revenue comes from dividends from our Bank subsidiary. These dividends are the principal source of funds to pay dividends on our common and preferred stock, and to pay interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that our Bank subsidiary and nonbank subsidiary may pay to us. Also, our right to participate in a distribution of assets upon a subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors. In the event our bank subsidiary is unable to pay dividends to us, we may not be able to service debt, pay obligations, or pay dividends on our common and preferred stock. The inability to receive dividends from our bank subsidiary could have a material adverse effect on our business, financial condition, and results of operations.

RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK

The market price for our common stock varies, and you should purchase common stock for long-term investment only.

Although our common stock is currently traded on the NASDAQ Global Select Market, we cannot assure you that there will, at any time in the future, be an active trading market for our common stock. Even if there is an active trading market for our common stock, we cannot assure you that you will be able to sell all of your shares of common stock at one time or at a favorable price, if at all. As a result, you should purchase shares of common stock described herein only if you are capable of, and seeking, to make a long-term investment in our common stock.

There may be future sales or other dilution of our equity, which may adversely affect the market price of our common stock.

We are not restricted from issuing additional shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. We are currently authorized to issue up to 50,000,000 shares of common stock and up to 210,000 shares of preferred stock, par value $100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized.

As of December 31, 2010, 10,937,506 shares of common stock and 183,259 shares of our preferred stock were issued and outstanding including (i) 7,503 shares of our fixed rate cumulative perpetual Series A preferred stock, par value $100 per share, having a liquidation preference of $5,000 per share, which we refer to as the TARP preferred stock, (ii) 1,533 shares of our Series A 3% cumulative preferred stock, which we refer to as the 3% preferred stock, and (iii) 174,223 shares of Series B-1 8.48% cumulative preferred stock, which we refer to as the 8.48% preferred stock. We refer to our TARP preferred stock, our 3% preferred stock and our 8.48% preferred stock collectively as the preferred stock. Our Board of Directors has authority, without action or vote of the shareholders, to issue all or part of the authorized but unissued shares. These authorized but unissued shares could be issued on terms or in circumstances that could dilute the interests of the holders of our common stock.

Pursuant to the Letter Agreement, dated December 23, 2008, and the Securities Purchase Agreement - Standard Terms attached thereto, which we refer to collectively as the Securities Purchase Agreement, that we entered into with the Treasury, in connection with our participation in TARP, the Treasury received a warrant to purchase up to 378,175 shares of our common stock, which we refer to as the warrant, at an exercise price of $14.88 per share, and we have provided the Treasury with registration rights covering the warrant and the underlying shares of common stock. We may seek the approval of our regulators to repurchase the warrant with the proceeds from any offering. The issuance of additional shares of common stock as a result of exercise of the warrant or otherwise or the issuance of securities convertible or exercisable into shares of common stock would dilute the ownership interest of existing holders of our common stock. Although the Treasury has agreed to not vote any of the shares of common stock it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any shares of common stock acquired upon exercise of the warrant is not bound by this restriction. The market price of our common stock could decline as a result of any offering as well as other sales of a large block of common stock in the market after an offering, or the perception that such sales could occur.

The terms of the warrant include an anti-dilution adjustment, which provides that (except in certain permitted transactions, including registered offerings), if we issue shares of common stock at a price that is less than 90% of the market price of such shares on the last trading day preceding the date of the agreement to sell such shares, the number of shares of common stock to be issued under the warrant would increase and the per share price of common stock to be purchased pursuant to the warrant would decrease.

Our shares of common stock are equity and are subordinate to our existing and future indebtedness and our preferred stock, and are effectively subordinated to all the indebtedness and other non-common equity claims against our subsidiaries.

Our shares of common stock are equity interests in us and do not constitute indebtedness. Accordingly, our common stock will rank junior to all of our indebtedness and to other non-equity claims on us with respect to assets available to satisfy claims on us. Additionally, holders of our common stock are subject to the prior dividend and liquidation rights of holders of our outstanding preferred stock. See Note 11, Shareholders Equity, in the accompanying consolidated financial statements. The terms of our preferred stock currently prohibit us from paying dividends with respect to our common stock unless all accrued and unpaid dividends for all completed dividend periods with respect to the preferred stock have been paid with our TARP preferred stock and 3% preferred stock receiving payments first.

In addition, our right to participate in any distribution of assets of any of our subsidiaries upon the subsidiary s liquidation or otherwise, and thus your ability as a holder of our common stock to benefit indirectly from such distribution, will be subject to the prior claims of creditors of that subsidiary and holders of any of that subsidiary s preferred stock, except to the extent that any of our claims as a creditor of such subsidiary may be recognized. As a result, our common stock will effectively be subordinated to all existing and future liabilities and obligations of our subsidiaries.

We may not pay dividends on our common stock.

Holders of our common stock are only entitled to receive such dividends as our Board of Directors may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so and may reduce or eliminate our common stock dividend in the future. This could adversely affect the market price of our common stock. Also, participation in TARP limits our ability to increase our dividend or to repurchase our common stock, for so long as any securities issued under such program remain outstanding, as discussed in greater detail below.

Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect.

Provisions of our certificate of incorporation, our bylaws, and federal and state banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. The combination of these provisions may discourage others from initiating a potential merger, takeover or other change of control transaction, which, in turn, could adversely affect the market price of our common stock.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. Additionally, we are obligated under a lease commitment through 2017 for a regional administrative facility in Pittsford, New York.

We are engaged in the banking business through 50 branch offices, of which 34 are owned and 16 are leased, in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2023 and generally include options to renew.

We believe that our properties have been adequately maintained, are in good operating condition and are suitable for our business as presently conducted, including meeting the prescribed security requirements. For additional information, see Note 5, Premises and Equipment, Net, and Note 9, Commitments and Contingencies, in the accompanying financial statements included in Part II, Item 8, Financial Statements and Supplementary Data , all of which are included elsewhere in this report and incorporated herein by reference thereto.

ITEM 3. LEGAL PROCEEDINGS

From time to time we are a party to or otherwise involved in legal proceedings arising in the normal course of business. Management does not believe that there is any pending or threatened proceeding against us, which, if determined adversely, would have a material adverse effect on our business, results of operations or financial condition.

ITEM 4. RESERVED

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At December 31, 2010, 10,937,506 shares of our common stock were outstanding and held by approximately 1,300 shareholders of record. During 2010, the high sales price of our common stock was $20.74 and the low sales price was $10.91. The closing price per share of common stock on December 31, 2010, the last trading day of the Company s fiscal year, was $18.97. We declared dividends of $0.40 per common share during the year ended December 31, 2010. See additional information regarding the market price and dividends paid in Part II, Item 6, Selected Financial Data.

We have paid regular quarterly cash dividends on our common stock and our Board of Directors presently intends to continue this practice, subject to our results of operations and the need for those funds for debt service and other purposes. However, the payment of dividends is subject to continued compliance with minimum regulatory capital requirements and TARP restrictions. See the discussions in the section captioned Supervision and Regulation included in Part I, Item 1, Business , in the section captioned Liquidity and Capital Resources included in Part II, Item 7, in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 10, Regulatory Matters, in the accompanying financial statements included in Part II, Item 8, Financial Statements and Supplementary Data , all of which are included elsewhere in this report and incorporated herein by reference thereto.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2010, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	560,689(1)	$ 20.64(1)	748,101(2)
Equity compensation plans not approved by shareholders		$	

(1) Includes 150,796 shares of unvested restricted stock awards outstanding as of December 31, 2010. The weighted average exercise price excludes such awards.

(2)

Represents the 940,000 aggregate shares approved for issuance under our two active equity compensation plans, reduced by 191,899 shares, which are the 117,012 restricted stock awards issued under these plans to date plus an adjustment of 74,887 shares. Pursuant to the terms of the plans, for purposes of calculating the number of shares available for issuance, each share of common stock granted pursuant to a restricted stock award shall count as 1.64 shares of common stock.

Sales of Unregistered Securities

2009 Management Incentive Plan

On May 6, 2009, our shareholders approved our 2009 Management Stock Incentive Plan. Pursuant to the terms of the 2009 Management Stock Incentive Plan, we have the ability to grant incentive stock options, non-qualified stock options and restricted stock to members of our management team. Between May 6, 2009 and December 31, 2010, we granted shares of restricted stock to members of our management team under the 2009 Management Stock Incentive Plan as described in the table below.

Date	Number of shares issued	Number of individuals receiving awards
October 1, 2009	1,972	1
January 13, 2010	40,188	5
February 23, 2010	59,152	23
December 15, 2010	500	1

These shares of restricted stock were issued without registration under the Securities Act of 1933, as amended (the Securities Act) in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

2009 Directors Stock Incentive Plan

On May 6, 2009, our shareholders approved our 2009 Directors Stock Incentive Plan. Pursuant to the terms of the 2009 Directors Stock Incentive Plan, we have the ability to grant non-qualified stock options and restricted stock to our non-employee directors. On May 6, 2009, we granted a total of 8,000 shares of restricted stock to ten of our non-employee directors and on May 6, 2010, we granted a total of 7,200 shares of restricted stock to nine of our non-employee directors.

These shares of restricted stock were issued without registration under the Securities Act in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2005 as reported by the NASDAQ Global Select Market, through December 31, 2010, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by SNL Financial L.C., of Major Exchange (NYSE, AMEX and NASDAQ) Banks with $1 billion to $5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL Financial, LC and is expressed in dollars based on an assumed investment of $100.

Total Return Performance

	Period Ending					
Index	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**
Financial Institutions, Inc.	100.00	119.37	94.50	78.59	67.41	111.16
NASDAQ Composite	100.00	110.39	122.15	73.32	106.57	125.91
SNL Bank $1B-$5B Index	100.00	115.72	84.29	69.91	50.11	56.81

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ITEM 6. SELECTED FINANCIAL DATA

	At or for the year ended December 31,				
(Dollars in thousands, except selected ratios and per share data)	**2010**	**2009**	**2008**	**2007**	**2006**
Selected financial condition data:					
Total assets	$ 2,214,307	$ 2,062,389	$ 1,916,919	$ 1,857,876	$ 1,907,552
Loans, net	1,325,524	1,243,265	1,102,330	948,652	909,434
Investment securities	694,530	620,074	606,038	754,720	775,536
Deposits	1,882,890	1,742,955	1,633,263	1,575,971	1,617,695
Borrowings	103,877	106,390	70,820	68,210	87,199
Shareholders equity	212,144	198,294	190,300	195,322	182,388
Common shareholders equity [(1)]	158,359	144,876	137,226	177,741	164,765
Tangible common shareholders equity [(2)]	120,990	107,507	99,577	139,786	126,502
Selected operations data:					
Interest income	$ 96,509	$ 94,482	$ 98,948	$ 105,212	$ 103,070
Interest expense	17,720	22,217	33,617	47,139	43,604
Net interest income	78,789	72,265	65,331	58,073	59,466
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Net interest income after provision (credit) for loan losses	72,102	64,563	58,780	57,957	61,308
Noninterest income (loss) [(3)]	19,454	18,795	(48,778)	20,680	21,911
Noninterest expense	60,917	62,777	57,461	57,428	59,612
Income (loss) before income taxes	30,639	20,581	(47,459)	21,209	23,607
Income tax expense (benefit)	9,352	6,140	(21,301)	4,800	6,245
Net income (loss)	$ 21,287	$ 14,441	$ (26,158)	$ 16,409	$ 17,362
Preferred stock dividends and accretion	3,725	3,697	1,538	1,483	1,486
Net income (loss) applicable to common shareholders	$ 17,562	$ 10,744	$ (27,696)	$ 14,926	$ 15,876
Stock and related per share data:					
Earnings (loss) per common share:					
Basic	$ 1.62	$ 0.99	$ (2.54)	$ 1.34	$ 1.40
Diluted	1.61	0.99	(2.54)	1.33	1.40
Cash dividends declared on common stock	0.40	0.40	0.54	0.46	0.34
Common book value per share [(1)]	14.48	13.39	12.71	16.14	14.53
Tangible common book value per share [(2)]	11.06	9.94	9.22	12.69	11.15
Market price (NASDAQ: FISI):					
High	20.74	15.99	22.50	23.71	25.38
Low	10.91	3.27	10.06	16.18	17.43
Close	18.97	11.78	14.35	17.82	23.05

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets.

(3) The 2010, 2009 and 2008 figures include other-than-temporary impairment (OTTI) charges of $594 thousand, $4.7 million and $68.2 million, respectively. There were no OTTI charges in the other years presented.

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(Dollars in thousands, except per share data)	At or for the year ended December 31, 2010	2009	2008	2007	2006
Selected financial ratios and other data:					
Performance ratios:					
Net income (loss), returns on:					
Average assets	0.98%	0.71%	-1.37%	0.86%	0.90%
Average equity	10.07	7.43	-14.30	8.84	9.86
Average common equity (1)	11.14	7.61	-16.84	8.89	10.02
Average tangible common equity (2)	14.59	10.37	-21.87	11.50	13.23
Common dividend payout ratio (3)	24.69	40.40	NA	34.33	24.29
Net interest margin (fully tax-equivalent)	4.07	4.04	3.93	3.53	3.55
Efficiency ratio (4)	60.36%	65.52%	64.07%	68.77%	69.78%
Capital ratios:					
Leverage ratio	8.31%	7.96%	8.05%	9.35%	8.91%
Tier 1 risk-based capital	12.34	11.95	11.83	15.74	15.85
Total risk-based capital	13.60	13.21	13.08	16.99	17.10
Equity to assets (5)	9.75	9.55	9.60	9.73	9.08
Common equity to assets (1) (5)	7.28	6.94	8.63	8.81	8.17
Tangible common equity to tangible assets (2) (5)	5.65%	5.19%	6.78%	6.95%	6.32%
Asset quality:					
Non-performing loans	$ 7,582	$ 8,681	$ 8,196	$ 8,077	$ 15,840
Non-performing assets	8,895	10,442	9,252	9,498	17,043
Allowance for loan losses	20,466	20,741	18,749	15,521	17,048
Net loan charge-offs	$ 6,962	$ 5,710	$ 3,323	$ 1,643	$ 1,341
Total non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Total non-performing assets to total assets	0.40	0.51	0.48	0.51	0.89
Net charge-offs to average loans	0.54	0.47	0.32	0.18	0.14
Allowance for loan losses to total loans	1.52	1.64	1.67	1.61	1.84
Allowance for loan losses to non-performing loans	270%	239%	229%	192%	108%
Other data:					
Number of branches	50	50	51	50	50
Full time equivalent employees	577	572	600	621	640

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets.

(3) Common dividend payout ratio equals dividends declared during the year divided by earnings per share for the year. There is no ratio shown for years where we both declared a dividend and incurred a loss because the ratio would result in a negative payout since the dividend declared (paid out) will always be greater than 100% of earnings.

(4) Efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities, proceeds from company owned life insurance included in income, and net gains from the sale of trust relationships (all from continuing operations).

(5) Ratios calculated using average balances for the periods shown.

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SELECTED QUARTERLY DATA

	2010			
(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	$ 24,297	$ 24,186	$ 24,202	$ 23,824
Interest expense	4,229	4,393	4,526	4,572
Net interest income	20,068	19,793	19,676	19,252
Provision for loan losses	1,980	2,184	2,105	418
Net interest income, after provision for loan losses	18,088	17,609	17,571	18,834
Noninterest income	5,274	5,131	4,966	4,083
Noninterest expense	16,373	14,936	14,870	14,738
Income before income taxes	6,989	7,804	7,667	8,179
Income tax expense	1,891	2,141	2,469	2,851
Net income	$ 5,098	$ 5,663	$ 5,198	$ 5,328
Preferred stock dividends	933	932	931	929
Net income applicable to common shareholders	$ 4,165	$ 4,731	$ 4,267	$ 4,399
Earnings per common share [1]:				
Basic	$ 0.38	$ 0.44	$ 0.39	$ 0.41
Diluted	0.38	0.43	0.39	0.40
Market price (NASDAQ: FISI):				
High	$ 20.74	$ 19.94	$ 19.48	$ 15.40
Low	16.80	14.14	14.07	10.91
Close	18.97	17.66	17.76	14.62
Dividends declared	$ 0.10	$ 0.10	$ 0.10	$ 0.10

	2009			
(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	$ 24,390	$ 23,697	$ 23,302	$ 23,093
Interest expense	5,175	5,619	5,657	5,766
Net interest income	19,215	18,078	17,645	17,327
Provision for loan losses	1,088	2,620	2,088	1,906
Net interest income, after provision for loan losses	18,127	15,458	15,557	15,421
Noninterest income	5,183	4,406	4,515	4,691
Noninterest expense	15,117	15,142	16,440	16,078
Income before income taxes	8,193	4,722	3,632	4,034
Income tax expense	2,756	1,313	1,004	1,067

Net income	$	5,437	$	3,409	$	2,628	$	2,967
Preferred stock dividends		927		927		925		918
Net income applicable to common shareholders	$	4,510	$	2,482	$	1,703	$	2,049
Earnings per common share [(1)]:								
Basic	$	0.42	$	0.23	$	0.16	$	0.19
Diluted		0.42		0.23		0.16		0.19
Market price (NASDAQ: FISI):								
High	$	12.25	$	15.00	$	15.99	$	14.95
Low		9.71		9.90		6.98		3.27
Close		11.78		9.97		13.66		7.62
Dividends declared	$	0.10	$	0.10	$	0.10	$	0.10

(1) Earnings per share data is computed independently for each of the quarters presented. Therefore, the sum of the quarterly earnings or loss per common share amounts may not equal the total for the year.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of our financial position and results of operations and should be read in conjunction with the information set forth under Part I, Item 1A, Risks Factors, and our consolidated financial statements and notes thereto appearing under Part II, Item 8, Financial Statements and Supplementary Data of this report.

OVERVIEW AND OUTLOOK

Business Overview

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in our Western and Central New York footprint. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, we provide brokerage services to supplement our banking business.

Our primary sources of revenue, are net interest income (predominantly from interest earned on our loans and securities, net of interest paid on deposits and other funding sources), and noninterest income, particularly fees and other revenue from financial services provided to customers or ancillary services tied to loans and deposits. Business volumes and pricing drive revenue potential, and tend to be influenced by overall economic factors, including market interest rates, business spending, consumer confidence, economic growth, and competitive conditions within the marketplace. We are not able to predict market interest rate fluctuations with certainty and our asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on our results of operations and financial condition.

Outlook

The general state of the U.S. economy and, in particular, economic and market conditions in Western and Central New York have a significant impact on loan demand, the ability of borrowers to repay loans and the value of any collateral securing loans and may also affect deposit levels. Accordingly, future general economic conditions and the impact on credit risk are key uncertainties that may materially affect our results of operations.

Approximately 20% of our investment securities portfolio at December 31, 2010 is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers. The concerns facing the State of New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York s debt obligations. However, the fallout from continued budgetary concerns and a possible ratings downgrade could adversely affect the value of New York s obligations.

Our interest rate spread affects our profitability. Our interest rate spread is the difference between the interest rate we receive on interest-earning assets, such as loans and investment securities, and the interest rate we pay on deposits and other borrowings. If the interest rates we pay on our deposits and other borrowings were to increase at a faster rate than the interest rates we receive on our loans and investments securities, our interest rate spread will decline, which could adversely affect our profitability.

Legislative and regulatory reforms continue to be adopted which impose additional restrictions on current business practices including passage of the Dodd-Frank Act. The Dodd-Frank Act is complex and we continue to assess how this legislation and subsequent rule-making will affect us. As hundreds of regulations are promulgated, we will continue to evaluate impacts such as changes in regulatory costs and fees, modifications to consumer products or disclosures required by the Consumer Financial Protection Bureau and the requirements of the enhanced supervision provisions, among others.

Recent Developments

On February 23, 2011, the Company was granted approval from the Treasury and redeemed $12.5 million of the $37.5 million in Series A preferred stock issued by the Company in December 2008. The redemption will result in a reduction of the associated Series A preferred stock dividends and Tier 1 Capital in future periods. Upon issuance in

December 2008, the discount associated with the Series A preferred stock was $2.0 million, which is being accreted to retained earnings as an adjustment to dividends using the effective yield method. At December 31, 2010, the Series A preferred stock discount totaled $1.3 million. As a result of the redemption, the Company will accelerate the accretion of the remaining discount in proportion to the Series A preferred stock redeemed in the first quarter of 2011. This transaction has no effect on the outstanding warrant to purchase common stock issued to the Treasury as part of the original issuance of the Series A preferred stock. The Company may apply for approval to repay the remaining balance of the Series A preferred stock in future periods.

MANAGEMENT S DISCUSSION AND ANALYSIS

2010 Performance Summary

Our reported net income was $21.3 million for the year ended December 31, 2010, compared to a net income of $14.4 million for the year ended December 31, 2009. For 2010, net income available to common shareholders was $17.6 million, or $1.61 per diluted common share. Net income available to common shareholders was $10.7 million for 2009, or $0.99 per diluted common share. Cash dividends of $0.40 per common share were paid in 2010 and 2009. We had total assets of $2.214 billion at December 31, 2010 compared to $2.062 billion at December 31, 2009. At December 31, 2010, shareholders equity totaled $212.1 million with book value per common share at $14.48, compared to $198.3 million with book value per share at $13.39 at the end of 2009. Tangible common equity to tangible common assets improved to 5.65% during 2010 from 5.19% in 2009. The Tier 1 capital ratio was 12.34% as of December 31, 2010 compared to 11.95% at December 31, 2009.

Key factors behind these results are discussed below.

At December 31, 2010, total gross loans (includes loans held for sale) were $1.349 billion, up 7% from year-end 2009, primarily in commercial mortgage and consumer indirect loans, as we have focused our business development efforts in these areas in accordance with our strategic objectives. Total deposits at December 31, 2010, were $1.883 billion, up 8% from year-end 2009, primarily attributable to a $113.6 million increase in retail deposits. Our deposit mix remains favorably weighted in lower cost demand, savings and money market accounts, which comprised 60.7% of total deposits at the end of 2010.

Nonperforming loans were $7.6 million at December 31, 2010, compared to $8.7 million at December 31, 2009, as our loan portfolio continues to benefit from responsible underwriting and lending practices.

Net charge-offs were $7.0 million in 2010 (or 0.54% of average loans) compared to $5.7 million in 2009 (or 0.47% of average loans). We had a $5.0 million participation interest in one commercial business loan, which was sold during the third quarter of 2010 for $1.9 million, resulting in a charge-off of $3.1 million.

The provision for loan losses was $6.7 million and $7.7 million, respectively, for 2010 and 2009. At year-end 2010, the allowance for loan losses of $20.5 million represented 1.52% of total loans (covering 270% of non-performing loans), compared to $20.7 million or 1.64% (covering 239% of non-performing loans) at year-end 2009. See also sections, Allowance for Loan Losses and Non-performing Assets and Potential Problem Loans for additional information on net charge-offs and non-performing loans.

Taxable equivalent net interest income was $80.7 million for 2010 or 8% higher than $75.0 million in 2009. Taxable equivalent interest income increased $1.2 million, while interest expense decreased by $4.5 million. The increase in taxable equivalent net interest income was a function of a favorable volume variance (increasing taxable equivalent net interest income by $6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by $573 thousand). See also section, Net Interest Income and Net Interest Margin for additional information on taxable equivalent net interest income and net interest margin.

The net interest margin for 2010 was 4.07%, 3 basis points higher than 4.04% in 2009. The increase in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). See also section, Net Interest Income and Net Interest Margin for additional information on taxable equivalent net interest income and net interest margin.

Noninterest income was $19.5 million for 2010 compared to $18.8 million for 2009. Core fee-based revenues (defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions) totaled $14.9 million for 2010, up $166 thousand from $14.7 million for 2009. Net mortgage banking income was $1.8 million for 2010, compared to $2.0 million in 2009, a decrease of $233 thousand from 2009, primarily attributable to lower secondary mortgage production experienced during 2010 and a decrease in our loan serviced for others portfolio. For additional discussion concerning noninterest income see section, Noninterest Income.

Net investment securities losses (defined as impairment charges on investment securities and net gain on disposal of investment securities) were $425 thousand for 2010, compared to net investment securities losses of $1.2 million for 2009, primarily attributable to other-than-temporary write-downs on investment securities.

Noninterest expense for 2010 was $60.9 million, a decrease of $1.9 million or 3% over 2009. FDIC assessments decreased $1.1 million, salaries and employee benefits decreased $823 thousand, and collectively all remaining noninterest expense categories were up $107 thousand or less than half a percent compared to 2009. Other noninterest expense for 2010 includes $1.0 million of losses relating to irregular instance of fraudulent debit card activity. The efficiency ratio (as defined under Part II, Item 6, Selected Financial Data) was 60.36% for 2010 and 65.52% for 2009. For additional discussion regarding noninterest expense see section, Noninterest Expense.

Income tax expense for 2010 was $9.4 million compared to $6.1 million for 2009. The change in income tax expense was primarily due to a $10.1 million increase in pretax income between the years. For additional discussion concerning income tax see section, Income Taxes.

MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2010 AND DECEMBER 31, 2009

Net Interest Income and Net Interest Margin

Net interest income is the primary source of our revenue. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and the interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

Interest rate spread and net interest margin are utilized to measure and explain changes in net interest income. Interest rate spread is the difference between the yield on earning assets and the rate paid for interest-bearing liabilities that fund those assets. The net interest margin is expressed as the percentage of net interest income to average earning assets. The net interest margin exceeds the interest rate spread because noninterest-bearing sources of funds (net free funds), principally noninterest-bearing demand deposits and stockholders equity, also support earning assets. To compare tax-exempt asset yields to taxable yields, the yield on tax-exempt investment securities is computed on a taxable equivalent basis. Net interest income, interest rate spread, and net interest margin are discussed on a taxable equivalent basis.

The following table reconciles interest income per the consolidated statements of operations to interest income adjusted to a fully taxable equivalent basis for the years ended December 31 (in thousands):

	2010	2009	2008
Interest income per consolidated statements of operations	$ 96,509	$ 94,482	$ 98,948
Adjustment to fully taxable equivalent basis	1,895	2,692	4,292
Interest income adjusted to a fully taxable equivalent basis	98,404	97,174	103,240
Interest expense per consolidated statement of operations	17,720	22,217	33,617
Net interest income on a taxable equivalent basis	$ 80,684	$ 74,957	$ 69,623

Taxable equivalent net interest income of $80.7 million for 2010 was $5.7 million or 8% higher than 2009. While the average yields on our loans and assets declined, the impact was far exceeded by the benefit of substantial loan production and asset growth. The average balance of loans rose $85.4 million to $1.295 billion, reflecting growth in the commercial and consumer indirect loan portfolios, as we have focused business development efforts in those areas, and the average balance of interest-earning assets rose $124.3 million to $1.981 billion, both increases of 7%. We will continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with our prudent underwriting standards.

The increase in taxable equivalent net interest income was a function of a favorable volume variance (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by $573 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by $6.8 million, while the change in volume and composition of interest-bearing liabilities increased interest expense by $499 thousand, for a net favorable volume impact of $6.3 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $5.6 million, while changes in rates on interest-bearing liabilities lowered interest expense by $5.0 million, for a net unfavorable rate impact of $573 thousand.

The net interest margin for 2010 was 4.07% compared to 4.04% in 2009. The 3 basis point improvement in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2010 and 2009.

For 2010, the yield on average earning assets of 4.97% was 26 basis points lower than 2009. Loan yields decreased 15 basis points to 5.86%. Commercial mortgage and consumer indirect loans in particular, down 26 and 34 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 69 basis points to 3.31%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by $5.6 million.

The cost of average interest-bearing liabilities of 1.10% in 2010 was 36 basis points lower than 2009. The average cost of interest-bearing deposits was 0.97% in 2010, 36 basis points lower than 2009, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 14 basis points to 3.33% for 2010. The interest-bearing liability rate changes resulted in $5.0 million lower interest expense.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Average interest-earning assets of $1.981 billion in 2010 were $124.3 million or 7% higher than 2009. Average investment securities increased $71.2 million, mostly in high quality U.S. Government agency securities. Average loans increased $85.4 million or 7%, with a $33.3 million increase in commercial loans and a $74.2 million increase in consumer loans, offset by a $22.1 million decrease in residential mortgage loans.

Average interest-bearing liabilities of $1.610 billion in 2010 were up $85.1 million or 6% versus 2009, mainly attributable to higher average retail deposit balances. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. On average, interest-bearing deposits grew $89.0 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by $36.0 million. Average wholesale funding decreased $3.9 million, net of the $6.0 million increase and $9.9 million decrease in short-term and long-term borrowings, respectively.

The recently enacted Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits for commercial accounts, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on us has not yet been determined, we expect interest costs associated with demand deposits to increase as a result of competitor responses to this change. See Part I, Item 1, Section Supervision and Regulation for a detailed discussion of this legislation.

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The following tables present, for the periods indicated, information regarding: (i) the average balance sheet; (ii) the amount of interest income from interest-earning assets and the resulting annualized yields (tax-exempt yields have been adjusted to a tax-equivalent basis using the applicable Federal tax rate in each year); (iii) the amount of interest expense on interest-bearing liabilities and the resulting annualized rates; (iv) net interest income; (v) net interest rate spread; (vi) net interest income as a percentage of average interest-earning assets (net interest margin); and (vii) the ratio of average interest-earning assets to average interest-bearing liabilities. Investment securities are at amortized cost for both held to maturity and available for sale securities. Loans include net unearned income, net deferred loan fees and costs and non-accruing loans. Dollar amounts are shown in thousands.

	Years ended December 31,								
	2010			2009			2008		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	$ 5,034	$ 10	0.21%	$ 37,214	$ 82	0.22%	$ 26,568	$ 619	2.33%
Investment securities:									
Taxable	571,856	17,101	2.99	454,552	16,466	3.62	487,687	21,882	4.49
Tax-exempt	108,900	5,416	4.97	155,054	7,920	5.11	233,864	13,065	5.59
Total investment securities	680,756	22,517	3.31	609,606	24,386	4.00	721,551	34,947	4.84
Loans:									
Commercial business	206,167	9,939	4.82	204,235	9,612	4.71	167,760	10,476	6.24
Commercial mortgage	338,149	20,389	6.03	306,763	19,309	6.29	274,677	18,877	6.87
Residential mortgage	138,954	8,157	5.87	161,055	9,701	6.02	172,083	10,761	6.25
Home equity	202,189	9,224	4.56	193,929	9,121	4.70	189,448	11,041	5.83
Consumer indirect	382,977	25,379	6.63	313,239	21,838	6.97	185,197	13,098	7.07
Other consumer	26,950	2,789	10.35	30,791	3,125	10.15	34,895	3,421	9.80
Total loans	1,295,386	75,877	5.86	1,210,012	72,706	6.01	1,024,060	67,674	6.61
Total interest-earning assets	1,981,176	98,404	4.97	1,856,832	97,174	5.23	1,772,179	103,240	5.83
Less: Allowance for loan losses	20,883			20,355			16,287		
Other noninterest-earning assets	206,303			197,439			149,453		

Total assets	$ 2,166,596			$ 2,033,916			$ 1,905,345		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	$ 382,517	705	0.18	$ 365,873	772	0.21	$ 347,702	3,246	0.93
Savings and money market	414,953	1,133	0.27	383,697	1,090	0.28	369,926	3,773	1.02
Certificates of deposit	726,330	13,015	1.79	685,259	17,228	2.51	617,381	22,330	3.62
Total interest-bearing deposits	1,523,800	14,853	0.97	1,434,829	19,090	1.33	1,335,009	29,349	2.20
Short-term borrowings	49,104	365	0.74	43,092	270	0.63	38,028	721	1.90
Long-term borrowings	37,043	2,502	6.75	46,913	2,857	6.09	53,687	3,547	6.61
Total borrowings	86,147	2,867	3.33	90,005	3,127	3.47	91,715	4,268	4.65
Total interest-bearing liabilities	1,609,947	17,720	1.10	1,524,834	22,217	1.46	1,426,724	33,617	2.36
Noninterest-bearing deposits	329,853			293,852			280,467		
Other liabilities	15,485			20,890			15,249		
Shareholders equity	211,311			194,340			182,905		
Total liabilities and shareholders equity	$ 2,166,596			$ 2,033,916			$ 1,905,345		
Net interest income (tax-equivalent)		$ 80,684			$ 74,957			$ 69,623	
Interest rate spread			3.87%			3.77%			3.47%
Net earning assets	$ 371,229			$ 331,998			$ 345,455		
Net interest margin (tax-equivalent)			4.07%			4.04%			3.93%
Ratio of average interest-earning assets to average interest-bearing liabilities	123.06%			121.77%			124.21%		

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Rate /Volume Analysis

The following table presents, on a tax equivalent basis, the relative contribution of changes in volumes and changes in rates to changes in net interest income for the periods indicated. The change in interest not solely due to changes in volume or rate has been allocated in proportion to the absolute dollar amounts of the change in each (in thousands):

	Change from 2010 to 2009			Change from 2009 to 2008		
Increase (decrease) in:	**Volume**	**Rate**	**Total**	**Volume**	**Rate**	**Total**
Interest income:						
Federal funds sold and other interest-earning deposits	$ (65)	$ (7)	$ (72)	$ 179	$ (716)	$ (537)
Investment securities:						
Taxable	3,807	(3,172)	635	(1,412)	(4,004)	(5,416)
Tax-exempt	(2,300)	(204)	(2,504)	(4,102)	(1,043)	(5,145)
Total investment securities	1,507	(3,376)	(1,869)	(5,514)	(5,047)	(10,561)
Loans:						
Commercial business	92	235	327	2,015	(2,879)	(864)
Commercial mortgage	1,916	(836)	1,080	2,097	(1,665)	432
Residential mortgage	(1,302)	(242)	(1,544)	(673)	(387)	(1,060)
Home equity	382	(279)	103	256	(2,176)	(1,920)
Consumer indirect	4,665	(1,124)	3,541	8,930	(190)	8,740
Other consumer	(396)	60	(336)	(414)	118	(296)
Total loans	5,357	(2,186)	3,171	12,211	(7,179)	5,032
Total interest income	**6,799**	**(5,569)**	**1,230**	**6,876**	**(12,942)**	**(6,066)**
Interest expense:						
Deposits:						
Interest-bearing demand	34	(101)	(67)	162	(2,636)	(2,474)
Savings and money market	86	(43)	43	135	(2,818)	(2,683)
Certificates of deposit	982	(5,195)	(4,213)	2,257	(7,359)	(5,102)
Total interest-bearing deposits	1,102	(5,339)	(4,237)	2,554	(12,813)	(10,259)
Short-term borrowings	41	54	95	85	(536)	(451)
Long-term borrowings	(644)	289	(355)	(426)	(264)	(690)
Total borrowings	(603)	343	(260)	(341)	(800)	(1,141)
Total interest expense	**499**	**(4,996)**	**(4,497)**	**2,213**	**(13,613)**	**(11,400)**
Net interest income	**$ 6,300**	**$ (573)**	**$ 5,727**	**$ 4,663**	**$ 671**	**$ 5,334**

MANAGEMENT S DISCUSSION AND ANALYSIS

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses was $6.7 million for the year ended December 31, 2010 compared with $7.7 million for 2009. See the Allowance for Loan Losses section for further discussion.

Noninterest Income (Loss)

The following table summarizes our noninterest income (loss) for the years ended December 31 (in thousands):

	2010	2009	2008
Service charges on deposits	$ 9,585	$ 10,065	$ 10,497
ATM and debit card	3,995	3,610	3,313
Broker-dealer fees and commissions	1,283	1,022	1,458
Company owned life insurance	1,107	1,096	563
Loan servicing	1,124	1,308	664
Net gain on sale of loans held for sale	650	699	339
Net gain on disposal of investment securities	169	3,429	288
Impairment charges on investment securities	(594)	(4,666)	(68,215)
Net (loss) gain on sale and disposal of other assets	(203)	180	305
Other	2,338	2,052	2,010
Total noninterest income (loss)	$ 19,454	$ 18,795	$ (48,778)

Service charges on deposits were $9.6 million in 2010, which was $480 thousand or 5% lower than 2009. The decrease was primarily attributable to lower nonsufficient funds fees in 2010, which were down $407 thousand to $7.9 million. In November 2009, the FRB issued a final rule that, effective July 1, 2010, prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions, commonly referred to as Reg.-E . Consumers must be provided a notice that explains the financial institution s overdraft services, including the fees associated with the service, and the consumer s choices. We implemented the provisions of Reg.-E in the third quarter of 2010 and the number of customers that have chosen to opt-in has exceeded our original expectations; however the extent of the adverse impacts of Reg.-E on our future service charge revenue is uncertain.

ATM and debit card income was $4.0 million for 2010, an increase of $385 thousand or 11%, compared to 2009, due to higher interchange fees resulting from an increase in the number of cardholders and an increase in customer transactions.

Broker-dealer fees and commissions were up $261 thousand or 26%, compared to 2009. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during 2010 as a result of improving market and economic conditions.

Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized mortgage servicing assets. Loan servicing income decreased $184 thousand for the year ended December 31, 2010 compared to 2009, mainly as a result of more rapid amortization of servicing rights due to loans paying off prior to maturity and lower fees collected due to a decrease in the sold and serviced portfolio.

We recognized $425 thousand in net losses on investment securities during the year ended December 31, 2010 as compared to $1.2 million of net losses during the same period in 2009. The investment security net losses for 2010 resulted from other-than-temporary impairment charges of $594 thousand, partly offset by $169 thousand of gains on the disposal of securities. The 2010 OTTI charges primarily relate to pooled trust preferred securities that were designated as impaired in the first quarter due to credit quality. The $1.2 million of investment security losses for 2009 are a result of $4.7 million of other-than-temporary impairment charges, partly offset by $3.4 million of gains on the sale of securities.

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Noninterest Expense

The following table summarizes our noninterest expense for the years ended December 31 (in thousands):

	2010	2009	2008
Salaries and employee benefits	$ 32,811	$ 33,634	$ 31,437
Occupancy and equipment	10,818	11,062	10,502
FDIC assessments	2,507	3,651	674
Computer and data processing	2,487	2,340	2,433
Professional services	2,197	2,524	2,141
Supplies and postage	1,772	1,846	1,800
Advertising and promotions	1,121	949	1,453
Other	7,204	6,771	7,021
Total noninterest expense	$ 60,917	$ 62,777	$ 57,461

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was $32.8 million for 2010, down $823 thousand or 2% from 2009. Average full-time equivalent employees (FTEs) were 577 for 2010, down 2% from 586 for 2009. Salary-related expenses were relatively unchanged at $25.3 million for 2010 and $25.2 million for 2009. Fringe benefit expenses decreased $876 thousand or 10%, primarily attributable to lower pension costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, decreased $1.1 million for the year ended December 31, 2010, due primarily to the one-time special assessment of $923 thousand incurred in the second quarter of 2009. FDIC assessment rates have also declined as a result of our improved financial ratios, upon which the assessment rate is based

Professional services expense of $2.2 million in 2010 decreased $327 thousand or 13% from 2009, primarily due to lower legal costs associated with loan workouts and other corporate activities.

Advertising and promotions expenses were $172 thousand or 18% higher in 2010 compared to 2009 due to increases in business development expenses.

Other noninterest expense increased $433 thousand or 6% during 2010 compared to 2009. This increase was primarily due to a loss of approximately $1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010. We have taken actions to limit our exposure to such fraudulent activity and we are reviewing the remedies that may by available. Any recoveries or other remedies received will be separate from the $1.0 million loss recorded in 2010 and will be recorded if and when received.

The efficiency ratio for the year ended December 31, 2010 improved to 60.36% compared with 65.52% for 2009. The efficiency ratio is a supplemental financial measure utilized in management s internal evaluations and is not defined under generally accepted accounting principles. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources.

Income Taxes

We recognized income tax expense of $9.4 million for 2010 compared to $6.1 million for 2009. The change in income tax expense was primarily due to a $10.1 million increase in pretax income between the years. We also recorded non-recurring tax benefits during 2010 of $1.2 million related to valuation of our deferred tax assets as a result of the NYS repeal of the experience method for determining bad debts and re-valuing at the highest Federal statutory rate of 35%. Our effective tax rates were 30.5% in 2010 and 29.8% in 2009. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits.

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RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2009 AND DECEMBER 31, 2008

Net Interest Income and Net Interest Margin

Net interest income in the consolidated statements of operations (which excludes the taxable equivalent adjustment) was $72.3 million in 2009 compared to $65.3 million in 2008. The taxable equivalent adjustments (the adjustments to bring tax-exempt interest to a level that would yield the same after-tax income had that income been subject to a taxation using a 34% tax rate) of $2.7 million and $4.3 million for 2009 and 2008, respectively, resulted in fully taxable equivalent net interest income of $75.0 million in 2009 and $69.6 million in 2008.

Taxable equivalent net interest income of $75.0 million for 2009 was $5.3 million or 8% higher than 2008. The increase in taxable equivalent net interest income was a combination of favorable volume variances (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $4.7 million) and favorable interest rate changes (as the impact of changes in the interest rate environment and product pricing increased taxable equivalent net interest income by $671 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by $6.9 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by $2.2 million, for a net favorable volume impact of $4.7 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $12.9 million, while changes in rates on interest-bearing liabilities lowered interest expense by $13.6 million, for a net favorable rate impact of $671 thousand.

The net interest margin for 2009 was 4.04%, compared to 3.93% in 2008. The 11 basis point improvement in net interest margin was attributable to a 30 basis point increase in interest rate spread (the net of a 90 basis point decrease in the cost of interest-bearing liabilities and a 60 basis decrease in the yield on earning assets), partially offset by a 19 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

For 2009, the yield on average earning assets of 5.23% was 60 basis points lower than 2008. Loan yields also decreased 60 basis points (to 6.01%). Commercial loans in particular, down 97 basis points, experienced lower yields given the repricing of adjustable rate loans and competitive pricing pressures in a low interest rate environment. The yield on securities and short-term investments was down 84 basis points to 4.00%, also impacted by the lower interest rate environment and prepayment speeds of mortgage-related investment securities purchased at a premium. Overall, earning asset rate changes reduced interest income by $12.9 million.

The cost of average interest-bearing liabilities of 1.46% in 2009 was 90 basis points lower than 2008. The average cost of interest-bearing deposits was 1.33% in 2009, 87 basis points lower than 2008, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 118 basis points to 3.47% for 2009, with short-term borrowings down 127 basis points and long-term borrowings down 52 basis points. The interest-bearing liability rate changes resulted in $13.6 million lower interest expense.

Average interest-earning assets of $1.857 billion in 2009 were $84.7 million or 5% higher than 2008. Average investment securities decreased $111.9 million as a result of mortgage-related investment securities sales and maturities. Average loans increased $186.0 million or 18%, with a $68.6 million increase in commercial loans and a $128.4 million increase in consumer loans, offset by a $11.0 million decrease in residential real-estate loans.

Average interest-bearing liabilities of $1.525 billion in 2009 were up $98.1 million or 7% versus 2008, attributable to higher average deposit balances. On average, interest-bearing deposits grew $99.8 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by $13.4 million. Average wholesale funding decreased $1.7 million, the net of $5.1 million increase and $6.8 million decrease in short-term and long-term borrowings, respectively.

Provision for Loan Losses

The provision for loan losses totaled $7.7 million for the year ended December 31, 2009, versus $6.6 million for 2008. The increase in the provision was due to increased net charge-offs and increases in loan portfolio outstandings during 2009. See the Allowance for Loan Losses section for further discussion.

Noninterest Income

Service charges on deposits were $10.1 million in 2009, which was $432 thousand or 4% lower than 2008. The decrease was primarily attributable to lower nonsufficient fund fees in 2009, which were down $505 thousand to $8.3 million, offset by an increase in other service charges, which increased by $73 thousand to $1.8 million in 2009.
ATM and debit card income was $3.6 million for 2009, an increase of $297 thousand or 9%, compared to 2008, as the increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage fees.

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Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized mortgage servicing assets. Loan servicing income increased $644 thousand for the year ended December 31, 2009 compared to 2008, mainly from an increase in the sold and serviced residential real estate portfolio and a recovery in the fair value of capitalized mortgage servicing assets.

We invested $20.0 million in company owned life insurance during the third quarter of 2008, resulting in the $533 thousand increase when comparing company owned life insurance income for the year ended December 31, 2009 to 2008.

Broker-dealer fees and commissions were down $436 thousand or 30%, compared to 2008. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which has declined during 2009 as a result of current market and economic conditions.

Net gain on sale of loans held for sale increased $360 thousand compared to the prior year, due primarily to higher gains on sales and related income resulting from increased volumes. Secondary mortgage production was $89.0 million for 2009, compared to $28.5 million for 2008. In addition, the 2008 income includes $104 thousand in net gains from the sale of student loans. We exited the student loan business in 2008.

The $3.4 million net gain on disposal of investment securities for 2009 is comprised of $6.8 million in gross gains, primarily from securities issued by U.S. government sponsored agencies, and $3.4 million in gross losses on sales of privately issued whole loan CMOs and auction rate securities. The $288 thousand net gain on disposal of investment securities for 2008 is comprised of $291 thousand in gross gains and $3 thousand in gross losses.

The $4.7 million of impairment charges on investment securities for 2009 is comprised of valuation write-downs of $2.4 million on pooled trust preferred securities and $2.3 million on privately issued whole loan CMOs. The $68.2 million of impairment charges on investment securities for 2008 is comprised of valuation write-downs of $30.0 million on pooled TPS, $5.9 million on privately issued whole loan CMOs and $32.3 million on auction-rate securities.

Noninterest Expense

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was $33.6 million for 2009, up $2.2 million or 7% from 2008. Average FTEs were 586 for 2009, down 4% from 610 for 2008. Salary-related expenses were relatively unchanged at $25.2 million for 2009 and $25.1 million for 2008, a result of fewer FTEs offset by higher incentives and commissions. Fringe benefit expenses increased $2.1 million or 34%, primarily from higher pension and post-retirement benefit costs.

Compared to 2008, occupancy and equipment expenses of $11.1 million were up $560 thousand or 5%, primarily a result of additional expenses related to the opening of two new branches at the end of 2008, combined with increased software maintenance costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, increased $3.0 million for the year ended December 31, 2009. The increases resulted from a combination of an increase in deposit levels subject to insurance premiums, higher FDIC insurance premium rates during 2009 and a $923 thousand special assessment during the second quarter of 2009, coupled with utilization of approximately $451 thousand in carryforward credits that reduced expense during the first nine months of 2008.

Professional services expense of $2.5 million in 2009 increased $383 thousand or 18% from 2008, primarily due to higher legal and other professional consultant costs associated with loan workouts and other corporate activities and projects.

Advertising and promotions expense of $949 thousand and other noninterest expense of $6.8 million, collectively, were down $754 thousand or 9%, reflecting efforts to control selected discretionary expenses.

The efficiency ratio for the year ended December 31, 2009 was 65.52% compared with 64.07% for 2008. The diminished efficiency ratio is reflective of noninterest expense increasing by larger margin than the higher level of net interest income. The efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities and proceeds from company owned life insurance included in income.

Income Taxes

We recognized income tax expense of $6.1 million for 2009 compared to an income tax benefit of $21.3 million for 2008. The change in income tax was primarily due to us having pre-tax income for 2009 versus a pre-tax loss for 2008. Our effective tax rates were 29.8% in 2009 and (44.9%) in 2008. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits. The unusual 2008 effective tax benefit rate results from the relationship between the size of the favorable permanent differences and pre-tax loss.

MANAGEMENT S DISCUSSION AND ANALYSIS

2010 FOURTH QUARTER RESULTS

Net income was $5.1 million for the fourth quarter of 2010 compared with $5.4 million for the fourth quarter of 2009. After preferred dividends, fourth quarter diluted earnings per share for 2010 was $0.38 compared with $0.42 per share for the fourth quarter of 2009.

Net interest income totaled $20.1 million for the three months ended December 31, 2010, an increase of $853 thousand or 4% over the fourth quarter of 2009. The increase in net interest income compared to the fourth quarter of 2009 resulted primarily from lower funding costs, a result of continued re-pricing of our certificates of deposit in the low rate environment. Average earning assets increased $102.2 million or 5% in the fourth quarter of 2010 compared with the fourth quarter last year, with most of the growth in the investment securities portfolio, and the indirect consumer and commercial mortgage loan portfolios. The increase in average indirect consumer loans reflected our continued expansion, including expansion of our dealer network into the Capital District of New York State.

The net interest margin on a tax-equivalent basis was 4.01% in the fourth quarter of 2010, compared with 4.06% in the fourth quarter of 2009. Our yield on earning-assets decreased 29 basis points in the fourth quarter of 2010 compared with the same quarter last year. This was due to the effect of reinvesting cash flows in the low interest rate environment and a substantial portion of earning asset growth being concentrated in lower yielding mortgage-backed securities. The cost of interest-bearing liabilities decreased 27 basis points compared with the fourth quarter of 2009 due to continued downward changes in our interest-bearing deposit rates, a result of the continued re-pricing of certificates of deposit.

Noninterest income totaled $5.3 million for the fourth quarter of 2010, a 2% increase over the fourth quarter of 2009.

Noninterest expense was $16.4 million for the fourth quarter of 2010, an increase of $1.3 million or 8% from the fourth quarter of 2009. This increase was primarily due to a loss of approximately $1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010.

Total assets at December 31, 2010 were $2.214 billion, down $35.2 million from $2.250 billion at September 30, 2010. Total gross loans (includes loans held for sale) were $1.349 billion and represented 61% of total assets at December 31, 2010, compared to $1.326 billion and 59% of total assets at September 30, 2010. Total investment securities were $694.5 million at December 31, 2010, down $25.1 million or 3% from September 30, 2010. Total deposits decreased $63.5 million to $1.883 billion at December 31, 2010, compared to $1.946 billion at September 30, 2010, due to seasonal reductions in public deposits. Lower cost demand, savings and money market accounts comprised 60.7% of total deposits at the end of 2010.

Total shareholders equity was $212.1 million at December 31, 2010, a $4.0 million decrease from September 30, 2010, due to a $7.5 million decrease in accumulated other comprehensive income, partially offset by a net increase of $3.1 million in our retained earnings. The decrease in accumulated comprehensive income was primarily related to a decrease in unrealized gains on investment securities from $13.0 million to $3.1 million driven by an increase in interest rates. Our tangible common equity as a percent of tangible assets was 5.56% as of December 31, 2010, with a tangible common book value per share of $11.06.

Non-performing assets were $8.9 million or 0.40% of total assets at December 31, 2010, up from $8.5 million at September 30, 2010. The ratio of non-performing loans to total loans was 0.56% at the end of the third and fourth quarters of 2010. The provision for loan losses was $2.0 million for the fourth quarter of 2010, compared to $2.2 million for the third quarter of 2010. Net charge-offs were $1.2 million, or 0.37% annualized, of average loans, down from $4.3 million, or 1.30% annualized, of average loans in the third quarter of 2010. The third quarter of 2010 included a $3.1 million charge-off related to one commercial business loan.

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ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2010, we had total assets of $2.214 billion, an increase of 7% from $2.062 billion as of December 31, 2009, primarily a result of the continued core business growth in both loans and deposits. Total gross loans (includes loans held for sale) were $1.349 billion as of December 31, 2010, up $84.7 million, or 7%, when compared to $1.264 billion as of December 31, 2009. The increase in loans was primarily attributed to the continued expansion of the indirect lending program in existing and new markets and commercial business development efforts. Non-performing assets totaled $8.9 million as of December 31, 2010, down $1.5 million from a year ago, due to decreases in both non-performing loans and investment securities for which we have stopped accruing interest. Total deposits amounted to $1.883 billion and $1.743 billion as of December 31, 2010 and 2009, respectively. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. As of December 31, 2010, total borrowed funds were $103.9 million, compared to $106.4 million as of December 31, 2009. Book value per common share was $14.48 and $13.39 as of December 31, 2010 and 2009, respectively. As of December 31, 2010 our total shareholders equity was $212.1 million compared to $198.3 million a year earlier.

INVESTING ACTIVITIES

The following table summarizes the composition of the available for sale and held to maturity security portfolios (in thousands).

Investment Securities Portfolio Composition
At December 31,

	2010		2009		2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 141,591	$ 140,784	$ 134,564	$ 134,105	$ 67,871	$ 68,173
State and political subdivisions	105,622	105,666	80,812	83,659	129,572	131,711
Mortgage-backed securities:						
Agency mortgage-backed securities	414,502	417,709	356,044	356,355	297,278	303,105
Non-Agency mortgage-backed securities	981	1,572	5,087	5,160	42,296	39,447
Asset-backed securities	564	637	1,295	1,222	3,918	3,918
Equity securities					923	1,152
Total available for sale securities	663,260	666,368	577,802	580,501	541,858	547,506
Securities held to maturity:						
State and political subdivisions	28,162	28,849	39,573	40,629	58,532	59,147
Total investment securities	$ 691,422	$ 695,217	$ 617,375	$ 621,130	$ 600,390	$ 606,653

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by ALCO, is responsible for investment portfolio decisions within the established policies.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than-temporary impairment includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

MANAGEMENT S DISCUSSION AND ANALYSIS

As of December 31, 2010, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2010, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in our consolidated statements of operations. The following discussion provides further details of our assessment of the securities portfolio by investment category.

The table below summarizes unrealized losses in each category of the securities portfolio at the end of the periods indicated (in thousands).

Unrealized Losses on Investment Securities At December 31,

	2010		2009		2008	
	Unrealized Losses	**% of Total**	**Unrealized Losses**	**% of Total**	**Unrealized Losses**	**% of Total**
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 1,965	31.6%	$ 545	19.8%	$ 307	7.3%
State and political subdivisions	1,472	23.6	3	0.1	42	1.0
Mortgage-backed securities:						
Agency mortgage-backed securities	2,655	42.7	1,638	59.3	981	23.1
Non-Agency mortgage-backed securities			330	12.0	2,854	67.3
Asset-backed securities	131	2.1	244	8.8		
Equity securities					52	1.2
Total available for sale securities	6,223	100.0	2,760	100.0	4,236	99.9
Securities held to maturity:						
State and political subdivisions					4	0.1
Total investment securities	$ 6,223	100.0%	$ 2,760	100.0%	$ 4,240	100.0%

U.S. Government Agencies and Government Sponsored Enterprises (GSE). As of December 31, 2010, there were 14 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, 7 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of $8.9 million and unrealized losses of $54 thousand. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

State and Political Subdivisions. As of December 31, 2010, the state and political subdivisions portfolio (municipals) totaled $133.9 million, of which $105.7 million was classified as available for sale. As of that date, $28.2 million was classified as held to maturity, with a fair value of $28.8 million. As of December 31, 2010, there were 95 municipals in an unrealized loss position, all of which were available for sale. These securities had an aggregate amortized cost of $39.9 million and unrealized losses of $1.5 million. There were no municipals in an unrealized loss position for 12 months or longer as of December 31, 2010. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

Agency Mortgage-backed Securities. With the exception of the non-Agency mortgage-backed securities (non-Agency MBS) discussed below, all of the mortgage-backed securities held by us as of December 31, 2010, were issued by U.S. Government sponsored entities and agencies (Agency MBS), primarily GNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2010, there were 36 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, only 4 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of $2.3 million and unrealized losses of $11 thousand. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2010, on such MBS to be credit related or other-than-temporary. As of December 31, 2010, we did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

MANAGEMENT S DISCUSSION AND ANALYSIS

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in three privately issued whole loan collateralized mortgage obligations with a fair value of $1.6 million and net unrealized gains of $591 thousand as of December 31, 2010. As of that date, each of the 3 non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. To date, we have recognized aggregate OTTI charges of $6.0 million due to reasons of credit quality against these securities, all of which was recorded prior to 2010.

Asset-backed Securities (ABS). As of December 31, 2010, the fair value of the ABS portfolio totaled $637 thousand and consisted of positions in 15 securities, the majority of which are pooled trust preferred securities (TPS) issued primarily by financial institutions and, to a lesser extent, insurance companies located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments, we considered the TPS to be non-performing and stopped accruing interest on the investments during 2009.

During 2010, we recognized OTTI charges totaling $594 thousand against 5 ABSs. Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of $32.9 million through December 31, 2010. We expect to recover the remaining amortized cost of $564 thousand on the securities. As of December 31, 2010, each of the securities in the ABS portfolio was rated below investment grade. There were 8 ABS in a loss position with an aggregate amortized cost of $338 thousand and unrealized losses totaling $131 thousand as of December 31, 2010. Of these, 6 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of $166 thousand and unrealized losses of $70 thousand. We determined at December 31, 2010 that the unrealized losses in the ABS portfolio are temporary.

Other Investments. As a member of the FHLB the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank s asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. Our ownership of FHLB stock, which totaled $2.5 million at December 31, 2010, is included in other assets and recorded at cost.

As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. FRB stock totaled $3.9 million at December 31, 2010, is included in other assets and recorded at cost.

LENDING ACTIVITIES

Total loans were $1.346 billion at December 31, 2010, an increase $82.0 million or 6% from December 31, 2009. Commercial loans increased $26.9 million or 5% and represented 41.9% of total loans at the end of 2010, compared to 42.5% at December 31, 2009. Residential mortgage loans were $129.6 million, down $14.6 million or 10% and represented 9.6% of total loans compared to 11.4% at December 31, 2009, while consumer loans increased $69.8 million to represent 48.5% of total loans at December 31, 2010 and 46.1% at December 31, 2009. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

Loan Portfolio Composition
At December 31,

	2010		2009		2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial business	$ 211,031	15.7%	$ 206,383	16.3%	$ 180,100	16.1%	$ 157,550	16.3%	$ 130,695	14.1%
Commercial mortgage	352,930	26.2	330,748	26.2	285,383	25.5	272,394	28.3	275,884	29.8
Total commercial	563,961	41.9	537,131	42.5	465,483	41.6	429,944	44.6	406,579	43.9
	129,580	9.6	144,215	11.4	177,683	15.8	166,863	17.3	163,244	17.6

Residential mortgage										
Home equity	208,327	15.5	200,684	15.9	189,794	16.9	194,144	20.1	203,426	22.0
Consumer indirect	418,016	31.1	352,611	27.9	255,054	22.8	134,977	14.0	106,445	11.5
Other consumer	26,106	1.9	29,365	2.3	33,065	2.9	38,245	4.0	46,788	5.0
Total consumer	652,449	48.5	582,660	46.1	477,913	42.6	367,366	38.1	356,659	38.5
Total loans	1,345,990	100.0%	1,264,006	100.0%	1,121,079	100.0%	964,173	100.0%	926,482	100.0%
Allowance for loan losses	20,466		20,741		18,749		15,521		17,048	
Total loans, net	$ 1,325,524		$ 1,243,265		$ 1,102,330		$ 948,652		$ 909,434	

The decrease in residential mortgage loans from $177.7 million to $144.2 million to $129.6 million for the periods ending December 31, 2008, 2009 and 2010, respectively, and the increase in consumer indirect loans from $255.1 million to $352.6 million to $418.0 million for the same periods reflects a strategic shift to increase our consumer indirect loan portfolio, while placing less emphasis on expanding our residential mortgage loan portfolio, coupled with our practice of selling the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

MANAGEMENT S DISCUSSION AND ANALYSIS

Commercial loans are generally viewed as having more inherent risk of default than residential mortgage or consumer loans. Also, the commercial loan balance per borrower is typically larger than that for residential mortgage and consumer loans, inferring higher potential losses on an individual customer basis. Commercial loans increased during 2010 as we continued our commercial business development efforts. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower s operations or on the value of underlying collateral, if any.

Commercial business loans were $211.0 million at the end of 2010, up $4.6 million or 2% since year-end 2009, and comprised 15.7% of total loans outstanding at December 31, 2010 compared to 16.3% at December 31, 2009. We typically originate business loans of up to $15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. Within the commercial business classification, loans to finance agricultural production totaled approximately 1% of total loans as of December 31, 2010.

Commercial mortgage loans totaled $352.9 million at December 31, 2010, up $22.2 million or 7% from December 31, 2009, and comprised 26.2% of total loans, unchanged from year-end 2009. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 51% of the commercial mortgage portfolio at December 31, 2010 was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area.

Our current lending standards for commercial real estate and real estate construction lending are determined by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value (LTV), requirements for pre-leasing and / or pre-sales, minimum debt-service coverage ratios, minimum borrower equity, and maximum loan to cost. Currently, the maximum standard for LTV is 80%, with lower limits established for certain higher risk types, such as raw land which has a 65% LTV maximum. Our LTV guidelines are in compliance with regulatory supervisory limits.

Residential mortgage loans totaled $129.6 million at the end of 2010, down $14.6 million or 10% from the prior year and comprised 9.6% of total loans outstanding at December 31, 2010 and 11.4% at December 31, 2009. Residential mortgage loans include conventional first lien home mortgages and we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. PMI insurance). As part of management s historical practice of originating and servicing residential mortgage loans, the majority of our fixed-rate residential mortgage loans are sold in the secondary market with servicing rights retained.

Our underwriting and risk-based pricing guidelines for consumer-related real estate loans consist of a combination of borrower FICO (credit score) and the LTV of the property securing the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production in 2010 was 759 compared to 763 in 2009. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled $652.4 million at December 31, 2010, up $69.8 million or 12% compared to 2009, and represented 48.5% of the 2010 year-end loan portfolio versus 46.1% at year-end 2009. Loans in this classification include indirect consumer, home equity and other consumer installment loans. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Consumer indirect loans amounted to $418.0 million at December 31, 2010 up $65.4 million or 19% compared to 2009, and represented 31.1% of the 2010 year-end loan portfolio versus 27.9% at year-end 2009. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily to individuals, but also to corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2010, we originated $204.4 million in indirect loans with a mix of approximately 33% new auto and 67% used vehicles. This compares with $199.1 million in indirect loans with a mix of approximately 32% new auto and 68% used vehicles for the same period in 2009. We do business with over 300 franchised auto dealers, primarily in Western and Central New York. During 2010, we continued to grow our indirect lending network by establishing relationships with dealerships in the Capital District of New York. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011.

Home equity consists of home equity lines, as well as home equity loans, some of which are first lien positions. Home equities amounted to $208.3 million at December 31, 2010 up $7.6 million or 4% compared to 2009, and represented 15.5% of the 2010 year-end loan portfolio versus 15.9% at year-end 2009. The portfolio had a weighted average LTV at origination of approximately 52% at December 31, 2010. Approximately 37% of the loans in the home equity portfolio are second lien positions at December 31, 2010.

Other consumer loans totaled $26.1 million at December 31, 2010, down $3.3 million or 11% compared to 2009, and represented 1.9% of the 2010 year-end loan portfolio versus 2.3% at year-end 2009. Other consumer consists of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Factors that are important to managing overall credit quality are sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an appropriate allowance for loan losses, and sound nonaccrual and charge off policies.

An active credit risk management process is used for commercial loans to further ensure that sound and consistent credit decisions are made. Credit risk is controlled by detailed underwriting procedures, comprehensive loan administration, and periodic review of borrowers outstanding loans and commitments. Borrower relationships are formally reviewed and graded on an ongoing basis for early identification of potential problems. Further analyses by customer, industry, and geographic location are performed to monitor trends, financial performance, and concentrations.

The loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2010, no significant concentrations, as defined above, existed in the Company s portfolio in excess of 10% of total loans.

Loans Held for Sale and Mortgage Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) totaled $3.1 million and $421 thousand as of December 31, 2010 and 2009, respectively, all of which were residential real estate loans.

We sell certain qualifying newly originated and refinanced residential real estate mortgages on the secondary market. The sold and serviced residential real estate loan portfolio decreased to $328.9 million as of December 31, 2010 from $349.8 million as of December 31, 2009. The decrease in the sold and serviced portfolio resulted from a decrease in residential loan origination and refinancing volumes associated with the interest rate environment during 2010 compared to 2009.

Allowance for Loan Losses

The following table summarizes the activity in the allowance for loan losses (in thousands).

	Loan Loss Analysis Year Ended December 31,				
	2010	**2009**	**2008**	**2007**	**2006**
Allowance for loan losses, beginning of year	$ 20,741	$ 18,749	$ 15,521	$ 17,048	$ 20,231
Charge-offs:					
Commercial business	3,426	2,360	720	618	1,472
Commercial mortgage	263	355	1,192	439	603
Residential mortgage	290	225	320	319	278
Home equity	259	195	110	255	108
Consumer indirect	4,669	3,637	2,011	988	532
Other consumer	909	1,058	1,106	1,276	1,206
Total charge-offs	9,816	7,830	5,459	3,895	4,199
Recoveries:					
Commercial business	326	428	684	1,140	1,777
Commercial mortgage	501	150	315	216	161
Residential mortgage	21	12	26	50	71
Home equity	36	20	19	12	22
Consumer indirect	1,485	1,030	548	235	224
Other consumer	485	480	544	599	603

Total recoveries	2,854	2,120	2,136	2,252	2,858
Net charge-offs	6,962	5,710	3,323	1,643	1,341
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Allowance for loan losses, end of year	$ 20,466	$ 20,741	$ 18,749	$ 15,521	$ 17,048
Net charge-offs to average loans	0.54%	0.47%	0.32%	0.18%	0.14%
Allowance to end of period loans	1.52%	1.64%	1.67%	1.61%	1.84%
Allowance to end of period non-performing loans	270%	239%	229%	192%	108%

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MANAGEMENT S DISCUSSION AND ANALYSIS

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which actual losses may occur. The total allowance is available to absorb losses from any segment of the loan portfolio (in thousands).

Allowance for Loan Losses by Loan Category
At December 31,

	2010		2009		2008		2007		2006	
	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial business	$ 3,712	15.7%	$ 4,407	16.3%	$ 3,300	16.1%	$ 2,505	16.3%	$ 3,294	14.1%
Commercial mortgage	6,431	26.2	6,638	26.2	4,635	25.5	4,640	28.3	5,494	29.8
Residential mortgage	1,013	9.6	1,251	11.4	2,516	15.8	1,763	17.3	1,748	17.6
Home equity	972	15.5	1,043	15.9	2,374	16.9	1,869	20.1	2,082	22.0
Consumer indirect	7,754	31.1	6,837	27.9	5,152	22.8	2,284	14.0	1,749	11.5
Other consumer	584	1.9	565	2.3	772	2.9	798	4.0	751	5.0
Unallocated (1)							1,662		1,930	
Total	$ 20,466	100.0%	$ 20,741	100.0%	$ 18,749	100.0%	$ 15,521	100.0%	$ 17,048	100.0%

(1) During 2008 management revised estimation techniques related to allocation of the allowance to specific loan segments. The result was the elimination of the unallocated portion of the allowance for loan losses and allocation of the entire balance to specific loan segments.

Management believes that the allowance for loan losses at December 31, 2010 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology that is described in further detail in Part I, Item I Business under the section titled Lending Activities . See also Critical Accounting Estimates for additional information on the allowance for loan losses.

Non-performing Assets and Potential Problem Loans

The following table sets forth information regarding non-performing assets (in thousands):

Non-performing Assets
At December 31,

2010	2009	2008	2007	2006

Non-accruing loans:					
Commercial business	$ 947	$ 650	$ 510	$ 839	$ 4,031
Commercial mortgage	3,100	2,288	2,670	3,294	7,671
Residential mortgage	2,102	2,376	3,365	2,987	3,127
Home equity	875	880	1,143	661	712
Consumer indirect	514	621	445	278	166
Other consumer	41	7	56	16	130
Total non-accruing loans	7,579	6,822	8,189	8,075	15,837
Restructured accruing loans					
Accruing loans contractually past due over 90 days	3	1,859	7	2	3
Total non-performing loans	7,582	8,681	8,196	8,077	15,840
Foreclosed assets	741	746	1,007	1,421	1,203
Non-performing investment securities	572	1,015	49		
Total non-performing assets	$ 8,895	$ 10,442	$ 9,252	$ 9,498	$ 17,043
Non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Non-performing assets to total assets	0.40%	0.51%	0.48%	0.51%	0.89%

MANAGEMENT S DISCUSSION AND ANALYSIS

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2010 were $8.9 million, a decrease of $1.5 million from the $10.4 million balance at December 31, 2009. The primary component of non-performing assets is non-performing loans, which were $7.6 million at December 31, 2010, a decrease of $1.1 million from the $8.7 million balance at December 31, 2009. The decrease in non-performing loans was attributable to a commercial relationship included in accruing loans past due 90 days or more at December 31, 2009 on which we collected substantially all of the $1.9 million balance during the first quarter of 2010, partially offset by a $757 thousand increase in non-accruing loans.

The ratio of non-performing loans to total loans was 0.56% at December 31, 2010, compared to 0.69% at December 31, 2009. This ratio continues to compare favorably to the average of our peer group, which was 3.53% of total loans at December 31, 2010, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of December 31, 2010 Top-tier bank holding companies having consolidated assets between $1 billion and $3 billion).

Non-accruing loans at December 31, 2010 were $7.6 million compared to $6.8 million at December 31, 2009. Approximately $3.3 million, or 43%, of the $7.6 million in non-accruing loans as of December 31, 2010 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. For non-accruing loans outstanding as of December 31, 2010, the amount of interest income forgone totaled $474 thousand. Included in nonaccrual loans are troubled debt restructurings (TDRs) of $534 thousand at December 31, 2010. We had no TDRs which were accruing interest as of December 31, 2010.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 13 properties totaling $741 thousand at December 31, 2010 and 14 properties totaling $746 thousand at December 31, 2009.

Non-performing investment securities for which we have stopped accruing interest were $572 thousand at December 31, 2010, a decrease of $443 thousand from the $1.0 million balance at December 31, 2009. The decrease in non-performing investment securities reflects net losses, both realized and unrealized, in our asset backed securities portfolio.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $11.5 million and $18.4 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2010 and 2009, respectively.

FUNDING ACTIVITIES

Deposits

The following table summarizes the composition of our deposits (dollars in thousands).

	At December 31,					
	2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 350,877	18.6%	$ 324,303	18.6%	$ 292,586	17.9%
Interest-bearing demand	374,900	19.9	363,698	20.9	344,616	21.1
Savings and money market	417,359	22.2	368,603	21.1	348,594	21.3
Certificates of deposit < $100,000	555,840	29.5	512,969	29.5	482,863	29.6
Certificates of deposit of $100,000 or more	183,914	9.8	173,382	9.9	164,604	10.1

Total deposits	$ 1,882,890	100.0%	$ 1,742,955	100.0%	$ 1,633,263	100.0%

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2010, total deposits were $1.883 billion, representing an increase of $139.9 million for the year. Certificates of deposit were approximately 39% of total deposits at both December 31, 2010 and 2009.

Nonpublic deposits, the largest component of our funding sources, represented 80% of total deposits and totaled $1.501 billion and $1.387 billion as of December 31, 2010 and 2009, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account. Nonpublic deposit levels continue to be positively impacted by the 2008 de novo branch expansion as our Henrietta and Greece branches have grown to $51.0 million and $34.6 million in deposits, respectively as of December 31, 2010. We had no brokered deposits outstanding at December 31, 2010 or 2009.

MANAGEMENT S DISCUSSION AND ANALYSIS

As an additional source of funding, we offer a variety of public deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of our total deposits. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. As of December 31, 2010, total public deposits were $382.2 million or 20% of total deposits, compared to $355.9 million or 20% of total deposits, as of December 31, 2009. In general, the number of public relationships remained stable in comparison to the prior year.

Short-term Borrowings

Short-term borrowings from the FHLB are used to satisfy funding requirements resulting from daily fluctuations in deposit, loan and investment activities. FHLB borrowings are collateralized by certain investment securities, FHLB stock owned by us and certain qualifying loans. At December 31, 2010, short-term borrowings consisted of Federal funds purchased of $38.2 million and $38.9 million of overnight repurchase agreements. At December 31, 2009, short-term borrowings consisted of Federal funds purchased of $9.4 million, $35.1 million of overnight repurchase agreements and a $15.0 million advance from the Federal Reserve s Term Auction Facility.

The following table summarizes information relating to our short-term borrowings (dollars in thousands).

	At or for the Year Ended December 31,		
	2010	2009	2008
Year-end balance	$ 77,110	$ 59,543	$ 23,465
Year-end weighted average interest rate	0.21%	0.59%	0.48%
Maximum outstanding at any month-end	$ 77,110	$ 85,912	$ 56,861
Average balance during the year	$ 49,104	$ 43,092	$ 38,028
Average interest rate for the year	0.74%	0.63%	1.90%

Long-term Borrowings

Long-term borrowings totaled $26.8 million at December 31, 2010 and consisted of $10.0 million in FHLB repurchase agreements, $65 thousand of FHLB amortizing advances and $16.7 million in junior subordinated debentures. At December 31, 2009, long-term borrowings totaled $46.8 million and consisted of $30.0 million in FHLB repurchase agreements, $145 thousand of FHLB amortizing advances and $16.7 million in junior subordinated debentures.

In February 2001, we established FISI Statutory Trust I (the Trust), which issued 16,200 fixed rate pooled trust preferred securities with a liquidation preference of $1,000 per security. The trust preferred securities represent an interest in our related junior subordinated debentures, which were purchased by the Trust and have substantially the same payment terms as these trust preferred securities. The subordinated debentures mature in 2031 and are the only assets of the Trust and interest payments from the debentures finance the distributions paid on the trust preferred securities. Distributions on the debentures are payable quarterly at a fixed interest rate equal to 10.20%. We incurred $487 thousand in costs related to the issuance that are being amortized over 20 years using the straight-line method. The Trust is accounted for as an unconsolidated subsidiary.

Shareholders Equity

Shareholders equity increased by $13.9 million in 2010 to $212.1 million at December 31, 2010, primarily due to net income of $21.3 million, partially offset by common and preferred dividends of $8.1 million. For detailed information on shareholders equity, see Note 11, Shareholders Equity, of the notes to consolidated financial statements.

The Company and Bank are subject to various regulatory capital requirements. At December 31, 2010, both the Company and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 10, Regulatory Matters, of the notes to consolidated financial statements.

GOODWILL

The carrying amount of goodwill totaled $37.4 million as of December 31, 2010 and 2009. The goodwill relates to our primary subsidiary and reporting unit, Five Star Bank. We perform a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant. On September 30, 2010, the Company performed the annual goodwill impairment test and determined the estimated fair value of our reporting unit to be in excess of its carrying amount. Accordingly, as of the annual impairment test date, there was no indication of goodwill impairment. We test goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting unit below its carrying amount.

Declines in the market value of our publicly traded stock price or declines in our ability to generate future cash flows may increase the potential that goodwill recorded on our consolidated statement of financial condition be designated as impaired and that we may incur a goodwill write-down in the future.

MANAGEMENT S DISCUSSION AND ANALYSIS

LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, our ability to sell or pledge securities, lines-of-credit, and access to the financial and capital markets. In addition, we currently have an effective shelf registration that allows for the ability to issue up to $50 million in common stock.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank s liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB.

The primary sources of liquidity for FII are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets. FSIS relies on cash flows from operations and funds from FII when necessary.

Our cash and cash equivalents were $39.1 million as of December 31, 2010, down from $43.0 million as of December 31, 2009. Our net cash provided by operating activities totaled $35.4 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled $169.2 million, which included net loan origination funding of $89.5 million and net securities transactions of $77.8 million. Net cash provided by financing activities of $129.9 million was attributed to the $139.9 million and $17.6 million increase in deposits and borrowings, respectively, partially offset by $20.1 million repayments of long-term debt and $7.7 million in cash paid for dividends.

Contractual Obligations and Other Commitments

The following table summarizes the maturities of various contractual obligations and other commitments (in thousands):

	At December 31, 2010				
	Within 1 year	**Over 1 to 3 years**	**Over 3 to 5 Years**	**Over 5 years**	**Total**
On-Balance sheet:					
Certificates of deposit [1]	$ 554,104	$ 141,608	$ 43,888	$ 154	$ 739,754
Long-term borrowings	10,065			16,702	26,767
Supplemental executive retirement plans	155	318	318	708	1,499
Off-Balance sheet:					
Limited partnership investments [2]	$ 695	$ 1,391	$ 695	$	$ 2,781
Commitments to extend credit [3]	357,240				357,240
Standby letters of credit [3]	4,075	1,216	1,233		6,524
Operating leases	1,218	2,188	1,933	5,868	11,207

(1) Includes the maturity of certificates of deposit amounting to $100 thousand or more as follows: $68.1 million in three months or less; $27.0 million between three months and six months; $58.5 million between six months and one year; and $30.3 million over one year.

(2)

We have committed to capital investments in several limited partnerships of up to $6.1 million. As of December 31, 2010, we have contributed $3.3 million to the partnerships, including $806 thousand during 2010.

(3) We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

Off-Balance Sheet Arrangements

With the exception of obligations in connection with our trust preferred securities and in connection with our irrevocable loan commitments, operating leases and limited partnership investments, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 9, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

MANAGEMENT S DISCUSSION AND ANALYSIS

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of our debt securities portfolio as of December 31, 2010. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. We have stopped accruing interest on our asset-backed securities. No tax-equivalent adjustments were made to the weighted average yields (in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	$	%	$ 59,324	2.25%	$ 60,113	2.48%	$ 22,154	1.40%	$ 141,591	2.21%
State and political subdivisions	17,186	3.53	43,177	3.10	45,259	2.19			105,622	2.78
Mortgage-backed securities	8,503	4.02	12,423	3.96	118,320	1.96	276,237	3.57	415,483	3.13
Asset-backed securities							564		564	
	25,689	3.69	114,924	2.75	223,692	2.15	298,955	3.41	663,260	2.88
Held to maturity debt securities:										
State and political subdivisions	21,439	2.43	5,490	4.13	1,055	5.08	178	5.53	28,162	2.88
	$ 47,128	3.12%	$ 120,414	2.82%	$ 224,747	2.16%	$ 299,133	3.41%	$ 691,422	2.88%

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2010. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial business	$ 130,990	$ 71,730	$ 8,311	$ 211,031
Commercial mortgage	80,096	161,978	110,856	352,930
Residential mortgage	25,556	57,534	46,490	129,580
Home equity	35,208	91,464	81,655	208,327
Consumer indirect	136,355	269,061	12,600	418,016
Other consumer	11,772	13,006	1,328	26,106

Total loans	$ 419,977	$ 664,773	$ 261,240	$ 1,345,990
Loans maturing after one year:				
With a predetermined interest rate		$ 205,867	$ 166,360	$ 372,227
With a floating or adjustable rate		458,906	94,880	553,786
Total loans maturing after one year		$ 664,773	$ 261,240	$ 926,013

MANAGEMENT S DISCUSSION AND ANALYSIS

Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components (in thousands):

	2010	2009
Total shareholders equity	$ 212,144	$ 198,294
Less: Unrealized gain on securities available for sale, net of tax	1,877	1,655
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(6,599)	(5,357)
Disallowed goodwill and other intangible assets	37,369	37,369
Disallowed deferred tax assets	14,608	17,214
Plus: Qualifying trust preferred securities	16,200	16,200
Tier 1 capital	$ 181,089	$ 163,613
Adjusted average total assets (for leverage capital purposes)	$ 2,177,911	$ 2,054,699
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	8.31%	7.96%
Total Tier 1 capital	$ 181,089	$ 163,613
Plus: Qualifying allowance for loan losses	18,363	17,153
Total risk-based capital	$ 199,452	$ 180,766
Net risk-weighted assets	$ 1,466,957	$ 1,368,653
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	12.34%	11.95%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	13.60%	13.21%

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with GAAP and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to our financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

We have numerous accounting policies, of which the most significant are presented in Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, valuation of goodwill and deferred tax assets, the valuation of securities and determination of OTTI, and accounting for defined benefit plans require particularly subjective or complex judgments important to our financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. We adjust these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from our estimates.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations, existing economic conditions, the fair value of underlying collateral, and other qualitative and quantitative factors which could affect probable credit losses. Because current economic conditions can change and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for loan losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for loan losses. Such agencies may require additions to the allowance for loan losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for loan losses is appropriate as recorded in the consolidated financial statements.

For additional discussion related to our accounting policies for the allowance for loan losses, see the sections titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements.

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. The Company completes the annual goodwill impairment test as of September 30 of each year. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. Currently, the Company s goodwill is evaluated at the entity level as there is only one reporting unit. The fair value of each reporting unit is compared to the recorded book value step one . If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and step two is not considered necessary. If the carrying value of a reporting unit exceeds its fair value, the impairment test continues (step two) by comparing the carrying value of the reporting unit s goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill.

Valuation of Deferred Tax Assets

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets resulting in additional income tax expense in the consolidated statements of operations. Management evaluates deferred tax assets on a quarterly basis and assesses the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Company s tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 14, Income Taxes, of the notes to consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Valuation and Other Than Temporary Impairment of Securities

We record all of our securities that are classified as available for sale at fair value. The fair value of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other corporate fixed maturities where we do not receive a public quotation are valued using a variety of acceptable valuation methods. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.

Securities are evaluated quarterly to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent or requirement to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors on securities not intended to be sold is recognized in other comprehensive income.

Defined Benefit Pension Plan

Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. We use a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions are reasonably possible and may have a material impact on our consolidated financial statements, results of operations or liquidity.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1, Summary of Significant Accounting Policies Recent Accounting Pronouncements, in the notes to consolidated financial statements for a discussion of recent accounting pronouncements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

The principal objective of our interest rate risk management is to evaluate the interest rate risk inherent in assets and liabilities, determine the appropriate level of risk to us given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by our Board of Directors. Management is responsible for reviewing with the Board of Directors our activities and strategies, the effect of those strategies on the net interest margin, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management has developed an Asset-Liability Policy that meets strategic objectives and regularly reviews the activities of the Bank.

Net Interest Income at Risk Analysis

The primary tool we use to manage interest rate risk is a rate shock simulation to measure the rate sensitivity of the statement of financial condition. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and economic value of equity. The following table sets forth the results of the modeling analysis as of December 31, 2010 (dollars in thousands):

Changes in	Net Interest Income			Economic Value of Equity		
interest rate	Amount	Change		Amount	Change	
+ 300 basis points	$ 80,089	$ (655)	(0.81)%	$ 409,884	$ (45,722)	(10.04)%
+ 200 basis points	80,387	(357)	(0.44)	428,304	(27,303)	(5.99)
+ 100 basis points	80,342	(402)	(0.50)	443,028	(12,578)	(2.76)
- 100 basis points	76,204	(4,540)	(5.62)	438,274	(17,332)	(3.80)

We measure net interest income at risk by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. As of December 31, 2010, a 100 basis point increase in rates would decrease net interest income by $402 thousand, or 0.5%, over the next twelve-month period. A 100 basis point decrease in rates would decrease net interest income by $4.5 million, or 5.6%, over a twelve-month period. As of December 31, 2010, a 100 basis point increase in rates would decrease the economic value of equity by $12.6 million, or 2.8%, over the next twelve-month period. A 100 basis point decrease in rates would decrease the economic value of equity by $17.3 million, or 3.8%, over a twelve-month period. This simulation is based on management s assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.

In addition to the changes in interest rate scenarios listed above, we typically run other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

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The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2010. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Borrowings include junior subordinated debentures. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2010				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Federal funds sold and interest-earning deposits in other banks	$	$ 94	$	$	$ 94
Investment securities	99,649	137,148	262,173	192,452	691,422
Loans	420,507	211,128	604,736	112,757	1,349,128
Total interest-earning assets	$ 520,156	$ 348,370	$ 866,909	$ 305,209	2,040,644
Cash and due from banks					38,964
Other assets [(1)]					134,699
Total assets					$ 2,214,307
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	$ 792,259	$	$	$	$ 792,259
Certificates of deposit	180,581	373,523	185,496	154	739.754
Borrowings	77,175	10,000		16,702	103,877
Total interest-bearing liabilities	$ 1,050,015	$ 383,523	185,496	16,856	1,635,890
Noninterest-bearing deposits					350,877
Other liabilities					15,396
Total liabilities					2,002,163
Shareholders equity					212,144
Total liabilities and shareholders equity					$ 2,214,307
Interest sensitivity gap	$ (529,859)	$ (35,153)	$ 681,413	$ 288,353	$ 404,754
Cumulative gap	$ (529,859)	$ (565,012)	$ 116,401	$ 404,754	

Cumulative gap ratio [2]	49.5%	60.6%	107.2%	124.7%
Cumulative gap as a percentage of total assets	(23.9)%	(25.5)%	5.3%	18.3%

(1) Includes net unrealized gain on securities available for sale and allowance for loan losses.

(2) Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

For purposes of interest rate risk management, we direct more attention on simulation modeling, such as net interest income at risk as previously discussed, rather than gap analysis. The net interest income at risk simulation modeling is considered by management to be more informative in forecasting future income at risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Financial Institutions, Inc. and its subsidiaries (the Company), as such term is defined in Exchange Act Rules 13a-15(f). The Company s system of internal control over financial reporting has been designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company s management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2010. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2010, the Company s internal control over financial reporting was effective.

The Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2010. That report appears herein.

/s/ Peter G. Humphrey
President and Chief Executive Officer
March 7, 2011

/s/ Karl F. Krebs
Executive Vice President and Chief Financial Officer
March 7, 2011

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also includes performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of the Company as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2010, and our report dated March 7, 2011 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Rochester, New York
March 7, 2011

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 7, 2011 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP
Rochester, New York
March 7, 2011

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Financial Condition

(Dollars in thousands, except share and per share data)	December 31, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 38,964	$ 42,874
Federal funds sold and interest-bearing deposits in other banks	94	85
Total cash and cash equivalents	39,058	42,959
Securities available for sale, at fair value	666,368	580,501
Securities held to maturity, at amortized cost (fair value of $28,849 and $40,629, respectively)	28,162	39,573
Loans held for sale	3,138	421
Loans (net of allowance for loan losses of $20,466 and $20,741, respectively)	1,325,524	1,243,265
Company owned life insurance	26,053	24,867
Premises and equipment, net	33,263	34,783
Goodwill	37,369	37,369
Other assets	55,372	58,651
Total assets	$ 2,214,307	$ 2,062,389
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 350,877	$ 324,303
Interest-bearing demand	374,900	363,698
Savings and money market	417,359	368,603
Certificates of deposit	739,754	686,351
Total deposits	1,882,890	1,742,955
Short-term borrowings	77,110	59,543
Long-term borrowings	26,767	46,847
Other liabilities	15,396	14,750
Total liabilities	2,002,163	1,864,095
Commitments and contingencies (Note 9)		
Shareholders equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized and issued	153	153
Series A preferred stock, $100 par value, 7,503 shares authorized and issued, aggregate liquidation preference of $37,515; net of $1,305 and $1,672 discount, respectively	36,210	35,843
Series B-1 8.48% preferred stock, $100 par value, 200,000 shares authorized, 174,223 shares issued	17,422	17,422
Total preferred equity	53,785	53,418
	113	113

Common stock, $0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued		
Additional paid-in capital	26,029	26,940
Retained earnings	144,599	131,371
Accumulated other comprehensive loss	(4,722)	(3,702)
Treasury stock, at cost 410,616 and 527,854 shares, respectively	(7,660)	(9,846)
Total shareholders equity	212,144	198,294
Total liabilities and shareholders equity	$ 2,214,307	$ 2,062,389

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations

(Dollars in thousands, except per share amounts)	Years ended December 31, 2010	2009	2008
Interest income:			
Interest and fees on loans	$ 75,877	$ 72,706	$ 67,674
Interest and dividends on investment securities	20,622	21,694	30,655
Other interest income	10	82	619
Total interest income	96,509	94,482	98,948
Interest expense:			
Deposits	14,853	19,090	29,349
Short-term borrowings	365	270	721
Long-term borrowings	2,502	2,857	3,547
Total interest expense	17,720	22,217	33,617
Net interest income	78,789	72,265	65,331
Provision for loan losses	6,687	7,702	6,551
Net interest income after provision for loan losses	72,102	64,563	58,780
Noninterest income (loss):			
Service charges on deposits	9,585	10,065	10,497
ATM and debit card	3,995	3,610	3,313
Broker-dealer fees and commissions	1,283	1,022	1,458
Company owned life insurance	1,107	1,096	563
Loan servicing	1,124	1,308	664
Net gain on sale of loans held for sale	650	699	339
Net gain on disposal of investment securities	169	3,429	288
Impairment charges on investment securities	(594)	(4,666)	(68,215)
Net (loss) gain on sale and disposal of other assets	(203)	180	305
Other	2,338	2,052	2,010
Total noninterest income (loss)	19,454	18,795	(48,778)
Noninterest expense:			
Salaries and employee benefits	32,811	33,634	31,437
Occupancy and equipment	10,818	11,062	10,502
FDIC assessments	2,507	3,651	674
Computer and data processing	2,487	2,340	2,433
Professional services	2,197	2,524	2,141
Supplies and postage	1,772	1,846	1,800
Advertising and promotions	1,121	949	1,453
Other	7,204	6,771	7,021
Total noninterest expense	60,917	62,777	57,461

Income (loss) before income taxes		30,639		20,581		(47,459)
Income tax expense (benefit)		9,352		6,140		(21,301)
Net income (loss)	$	21,287	$	14,441	$	(26,158)
Preferred stock dividends, net of accretion		3,725		3,697		1,538
Net income (loss) available to common shareholders	$	17,562	$	10,744	$	(27,696)
Earnings (loss) per common share (Note 15):						
Basic	$	1.62	$	0.99	$	(2.54)
Diluted	$	1.61	$	0.99	$	(2.54)

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders Equity
Years ended December 31, 2010, 2009 and 2008

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at January 1, 2008	**$ 17,581**	**$ 113**	**$ 24,778**	**$ 158,744**	**$ 667**	**$ (6,561)**	**$ 195,322**
Comprehensive income:							
Net loss				(26,158)			(26,158)
Other comprehensive loss, net of tax					(4,680)		(4,680)
Total comprehensive loss							(30,838)
Cumulative effect of adoption of new accounting pronouncements				(241)			(241)
Repurchase of common shares						(4,818)	(4,818)
Repurchase of Series A 3% preferred stock	(6)		3				(3)
Warrant issued in connection with Series A preferred stock			2,025				2,025
Issue shares of Series A preferred stock	37,515						37,515
Discount on Series A preferred stock	(2,025)						(2,025)
Share-based compensation plans:							
Share-based compensation			603	30			633
Stock options exercised			(12)			44	32
Restricted stock awards issued			(998)			998	
Directors retainer			(2)			114	112
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	9			(56)			(47)
Cash dividends declared:							
Series A 3% preferred-$3.00 per share				(5)			(5)
Series B-1 8.48% preferred-$8.48 per share				(1,477)			(1,477)
Common-$0.54 per share				(5,885)			(5,885)

Balance at December 31, 2008	**$ 53,074**	**$ 113**	**$ 26,397**	**$ 124,952**	**$ (4,013)**	**$ (10,223)**	**$ 190,300**
Comprehensive income:							
Net income				14,441			14,441
Other comprehensive income, net of tax					311		311
Total comprehensive income							14,752
Issuance costs of Series A preferred stock			(68)				(68)
Share-based compensation plans:							
Share-based compensation			852	2			854
Stock options exercised			(4)			19	15
Restricted stock awards issued, net			(207)			207	
Directors retainer			(30)			151	121
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	344			(537)			(193)
Cash dividends declared:							
Series A 3% preferred-$3.00 per share				(5)			(5)
Series A preferred-$223.61 per share				(1,678)			(1,678)
Series B-1 8.48% preferred-$8.48 per share				(1,477)			(1,477)
Common-$0.40 per share				(4,327)			(4,327)
Balance at December 31, 2009	**$ 53,418**	**$ 113**	**$ 26,940**	**$ 131,371**	**$ (3,702)**	**$ (9,846)**	**$ 198,294**

Continued on next page

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders Equity (Continued)
Years ended December 31, 2010, 2009 and 2008

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2009 *Balance carried forward*	**$ 53,418**	**$ 113**	**$ 26,940**	**$ 131,371**	**$ (3,702)**	**$ (9,846)**	**$ 198,294**
Comprehensive income:							
Net income				21,287			21,287
Other comprehensive loss, net of tax					(1,020)		(1,020)
Total comprehensive income							20,267
Purchases of treasury stock						(69)	(69)
Share-based compensation plans:							
Share-based compensation			1,031				1,031
Stock options exercised			(74)			290	216
Restricted stock awards issued, net			(1,853)			1,853	
Directors retainer			(15)			112	97
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	367			(367)			
Cash dividends declared:							
Series A 3% preferred-$3.00 per share				(5)			(5)
Series A preferred-$250.00 per share				(1,876)			(1,876)
Series B-1 8.48% preferred-$8.48 per share				(1,477)			(1,477)
Common-$0.40 per share				(4,334)			(4,334)
Balance at December 31, 2010	**$ 53,785**	**$ 113**	**$ 26,029**	**$ 144,599**	**$ (4,722)**	**$ (7,660)**	**$ 212,144**

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows

			Years ended December 31,			
(Dollars in thousands)	**2010**		**2009**		**2008**	
Cash flows from operating activities:						
Net income (loss)	$ 21,287	$	14,441	$	(26,158)	
Adjustments to reconcile net income (loss) to net cash provided by operating activities:						
Depreciation and amortization	3,537		4,067		3,959	
Net amortization of premiums on securities	3,005		2,587		390	
Provision for loan losses	6,687		7,702		6,551	
Share-based compensation	1,031		854		633	
Deferred income tax expense (benefit)	2,468		7,470		(23,848)	
Proceeds from sale of loans held for sale	42,195		90,290		28,685	
Originations of loans held for sale	(44,262)		(88,999)		(28,453)	
			(1,09d valign=bottom style=' padding:0in 5.4pt 0in 5.4pt'>			
Increase in company owned life insurance	(1,107)					
2005(3)	US$238	Php13,389	JP¥1,709	Php866	Php368	Php14,623
2006	337	18,947	3,418	1,732	847	21,526
2007	443	24,882	3,418	1,732	73	26,687
2008	118	6,630	1,709	866	61	7,557
2009	271	15,219			52	15,271
2010 and onwards	972	54,590			1,214	55,804

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(1) The exchange rate used was Php56.177 to US$1.00.

(2) The exchange rate used was Php0.5067 to JP¥1.00.

(3) July 1, 2005 through December31, 2005.

Approximately Php85,664 million principal amount of our consolidated outstanding long-term debt as at June 30, 2005 is scheduled to mature over the period from 2005 to 2009. Of this amount, approximately Php63,064 million is attributable to PLDT, Php18,751 million to Smart, and the remainder to Mabuhay Satellite, Maratel and ePLDT.

Debt Covenants

Our debt instruments contain restrictive covenants, including covenants that could prohibit us from paying common dividends under certain circumstances, and require us to comply with specified financial ratios and other financial tests, calculated in conformity with accounting principles generally accepted in the Philippines, at relevant measurement dates, principally at the end of each quarterly period. We have complied with all of our maintenance financial ratios as required under our loan covenants and other debt instruments.

Please see *Note 17 Interest-bearing Financial Liabilities* to the accompanying unaudited consolidated financial statements for a detailed discussion of our covenants.

Financing Requirements

We believe that our available cash, including cash flow from operations, will provide sufficient liquidity to fund our projected operating, investment, capital expenditures and debt service requirements for the next 12 months.

Since 2002, we have been utilizing internally generated cash particularly from our cellular business to reduce our overall level of indebtedness. In line with this objective, we have managed our capital expenditures, reduced our investments and suspended dividend payments to common shareholders from April 2001 to 2004. As a result of our improving cash flows and reduced debt levels, we have restored the payment of common dividends in May 2005 and intend to gradually increase our dividend payout ratio in succeeding years as we improve our leverage ratios.

Credit Ratings

None of our existing indebtedness contains provisions under which credit rating downgrades would trigger a default, changes in applicable interest rates or other similar terms and conditions.

On July 11, 2005, Fitch Ratings revised the outlook on PLDT s long-term foreign currency rating to negative from stable. The revision in outlook reflects a similar change in Fitch s outlook on the Republic of the Philippines BB long-term foreign currency rating to negative from stable. PLDT s long-term foreign currency rating, global bonds and senior notes has been maintained at BB and convertible preferred stock remain unchanged at B+. The outlook on PLDT s long-term local currency rating has also been affirmed as BB+ and the stable outlook on this rating still remains in place.

On May 3, 2005, Fitch Ratings upgraded PLDT s long-term local currency rating to BB+ with a stable outlook. Simultaneously, Fitch has affirmed PLDT s long-term foreign currency rating, global bonds and senior notes at BB and PLDT s convertible preferred stock at B+.

On February 16, 2005, Moody s Investor Service, or Moody s, downgraded the foreign currency senior unsecured debt rating of PLDT by one-notch to Ba3 from Ba2 with a stable outlook. The rating action was taken as part of Moody s two-notch downgrade of the Republic of the Philippines foreign currency country ceiling to B1 from Ba2. On the same date, Moody s affirmed PLDT s B1 preferred stock rating with a stable outlook. Moody's views that there is a differential between PLDT's foreign currency rating and the sovereign rating. According to Moody's, PLDT's foreign currency bond rating is a function of its own risk of default and is less likely to be subject to a debt moratorium which the Philippine government may declare in case of an event of default by government.

On January 17, 2005, Standard and Poor s Ratings Group, or Standard and Poor s, revised its long-term foreign currency rating on PLDT from BB to BB- (BB minus) with a stable outlook. The rating action was taken immediately after Standard and Poor s downgraded the foreign currency rating on the Republic of the Philippines to BB- (BB minus).

Equity Financing

PLDT raised Php131 million and Php64 million from the exercise by certain officers and executives of stock options in the first half of 2005 and 2004, respectively. In addition, through our subscriber investment plan, or SIP, which provides postpaid fixed line subscribers the opportunity to buy shares of our 10% cumulative convertible preferred stock as part of the upfront payments collected from subscribers, PLDT was able to raise Php2 million in the first half of 2005 and
Php4 million in the same period in 2004.

Cash dividend payments in the first half of 2005 amounted to Php2,963 million, of which Php2,372 million and Php591 million were paid to common and preferred shareholders, respectively, compared to Php601 million in the same period in 2004, all of which were paid to preferred shareholders of PLDT. On March 2, 2005, PLDT declared cash dividends of Php14 per common share to holders of record as at March 31, 2005 paid on May 12, 2005. This was the first cash dividend declaration to common shareholders in four years since April 2001. In addition, on May 5, 2005, PLDT declared cash dividend of Php21 per common share to holders of record as at June 3, 2005 paid on July 14, 2005.

Contractual Obligations and Commercial Commitments

Contractual Obligations

The following table discloses our contractual obligations outstanding as at June 30, 2005:

	Payments Due by Period				
	Total	**Within 1 year**	**2-3 years**	**4-5 years**	**After 5 years**
			(Unaudited)		
(in millions)					
Long-term debt (1)	Php141,468	Php29,036	Php38,385	Php21,173	Php52,874
Long-term lease obligations:					
Operating Lease	3,704	624	1,103	843	1,134
Capital Lease	1,742	760	524	13	445
Unconditional purchase obligations(2)	11,861	4,556	2,249	2,247	2,809
Other long-term obligations	19,633		5,853	13,780	
Total contractual obligations	Php178,408	Php34,976	Php48,114	Php38,056	Php57,262

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(1) Before deducting unamortized debt discount and debt issuance costs.

(2) Based on the original Air Time Purchase Agreement with AIL.

Long-term Debt

For a discussion of our long-term debt, see *Note 17 Interest-bearing Financial Liabilities* to the accompanying unaudited consolidated financial statements.

Long-term Operating Lease Obligations

Domestic Fiber Optic Network Submerged Plant Maintenance Agreement. On July 4, 2000, PLDT entered into an agreement with NTT World Engineering Marine Corporation, or NTT WEMC for the submarine cable repair and other related services in relation to the maintenance of PLDT's domestic fiber optic network, or DFON, submerged plant for a period of five years up to July 4, 2005. This agreement has been extended up to the end of 2005. Under this agreement, PLDT is required to pay NTT WEMC a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely-operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair. As at June 30, 2005, PLDT s aggregate remaining obligation under this agreement was approximately Php39 million.

Digital Passage Service Contracts. PLDT has existing Digital Passage Service Contracts with foreign telecommunication administrations for several dedicated circuits to various destinations for ten to 25 years expiring at various dates. As at June 30, 2005, PLDT s aggregate remaining obligation under these contracts amounted to approximately Php24 million.

License Agreement with Mobius Management Systems (Australia) Pty Ltd., or Mobius. PLDT entered into a license agreement with Mobius pursuant to which Mobius has granted PLDT a non-exclusive, non-assignable and non-transferable license for the use of computer software components. Under this agreement, Mobius is also required to provide maintenance services for a period of one year at no additional maintenance charge. PLDT may purchase maintenance services upon expiration of the first year for a fee of 15% of the current published license fee. As at June 30, 2005, PLDT s aggregate remaining obligation under this agreement was approximately
Php40 million.

Other Long-term Operating Lease Obligations. The PLDT Group has various long-term lease contracts for periods ranging from two to ten years covering certain offices, warehouses, cell sites, telecommunication equipment locations and various office equipment. In particular, Smart has lease obligations aggregating Php3,325 million as at June 30, 2005 in respect of office and cell site rentals with over 3,000 lessors nationwide. PLDT has lease obligations aggregating
Php96 million as at June 30, 2005, and ePLDT has lease obligations aggregating Php180 million as at June 30, 2005 in respect of certain office space rentals.

*Long-term Capital Lease Obligation*s

For a discussion of our long-term capital lease obligations, see *Note 17 Interest-bearing Financial Liabilities* to the accompanying unaudited consolidated financial statements.

Unconditional Purchase Obligations

Air Time Purchase Agreement with AIL. PLDT is a party to a Founder NSP, or National Service Provider, Air Time Purchase Agreement with AIL in March 1997, which was amended in December 1998, under which PLDT is granted the exclusive right to sell AIL services in the Philippines. In exchange, the Air Time Purchase Agreement required PLDT to purchase from AIL a minimum of US$5 million worth of air time annually over ten years commencing on January 1, 2002, the date of commercial operations of the Garuda I Satellite.

In the event that AIL s aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement also states that PLDT has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term.

PLDT and the other founder NSPs are endeavoring to amend the Air Time Purchase Agreement due to the occurrence of partial satellite loss, changes in the primary business of AceS and the other events affecting the business.

In March 2003, PLDT, together with the other founder NSPs, entered into a Standstill Agreement with AIL suspending the application and enforcement of the minimum and supplemental air time payments under the original Air Time Purchase Agreement. The parties agreed that AIL shall provide PLDT and the other founder shareholders, with unlimited use of air time for the year 2003 in exchange for a fixed fee in the amount of US$3.8 million for PLDT. Moreover, PLDT is also obliged to purchase from AIL 13,750 satellite phone units in 2003 at US$395 F.O.B. per unit, subject to quarterly price adjustments. The parties to the Standstill Agreement also agreed to negotiate in good faith and use their best efforts to reach an agreement on a revised Air Time Purchase Agreement before November 15, 2003 that will cover, among other things, the amended minimum and supplemental air time payment provisions subject to the approval of AIL s creditors.

On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement effective January 1, 2002 following the lapse of the November 15, 2003 deadline set in the Standstill Agreement for the negotiation of a revised Air Time Purchase Agreement.

As at June 30, 2005, PLDT s aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,857 million. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. See *Note 20 Related Party Transactions* and *Note 23 Provisions and Contingencies* to the accompanying unaudited consolidated financial statements for further details relating to the Air Time Purchase Agreement with AIL.

International Affiliate Agreement with VeriSign, Inc., or VeriSign. On September 15, 2000, ePLDT entered into an agreement with VeriSign for the non-exclusive, non-transferable right and license to use the VeriSign software, brand and Certification Practice Statement for the purpose of approving, issuing, suspending or revoking digital certificates for users of the internet or similar open systems in the Philippines for a period of seven years. Under this agreement, ePLDT is required to pay VeriSign a certain percentage of the revenue derived from the services subject to minimum annual royalty payments aggregating to US$11 million, which was subsequently reduced to US$1 million, for the seven-year contract period. In addition, ePLDT was required to pay an annual support fee totaling US$0.5 million during the first year and US$0.3 million in each year thereafter.

Effective July 1, 2003, VeriSign has agreed to amend the Agreement and issued Addendum 6 to write-off all past due invoices and payments owed to VeriSign, which were invoiced or scheduled to be invoiced under the agreement prior

to this Addendum 6. All royalty payments and annual support fees due through June 2003 were part of the write-off in the amount of
US$0.8 million. For contract year 4 (September 2003 to August 2004), the annual support fee was reduced from US$0.3 million to US$ 40,000 and for contract years 5 to 7 (September 2004 to August 2007) from US$0.3 million to US$0.16 million. In addition, VeriSign agreed to reduce the affiliate revenue sharing rates from 50% of suggested retail price to 25% of suggested retail price for both enterprise and internet products for 12 months starting July 2003 and negotiable thereafter.

Moreover, effective July 1, 2004, VeriSign has agreed to amend the Agreement and issued Addendum 8 as extension of Addendum 6. Under this amendment, annual support fee for year 5 (September 2004 to August 2005) will remain at US$40,000 and affiliate revenue sharing rates will remain at 25%. As at June 30, 2005, ePLDT s aggregate remaining minimum obligation under this agreement was approximately Php4 million pertaining to annual support fee.

License Purchase Agreement with I-Contact Solutions Pte. Ltd. On April 2, 2003, iPlus Intelligent Network Inc., or iPlus, a wholly-owned subsidiary of ePLDT and the Philippines pioneer in IP-based IT response center, entered into an Application Services Provider, or ASP, and Reseller Contract with I-Contact Solutions Pte. Ltd., or I-Contact, of Singapore. Under the agreement, iPlus will purchase licenses of the CosmoCall Universe IP-based contact center solution. CosmoCall Universe supports multi-channel customer interactions including telephone, web chat, web voice, web video, web collaboration, e-mail and voicemail in one high capacity, high availability, multi-tenant platform. CosmoCall Universe is a complete, unified contact center suite that includes ACD, IVR, CTI, predictive dialing, multimedia recording and a complement of other management applications. The aggregate value of these licenses is US$2.1 million and these licenses will be delivered quarterly over a two-year period. Further to the agreement, I-Contact will appoint iPlus as the exclusive reseller and ASP for the Philippine market and will provide iPlus with all the necessary support in terms of sales, marketing, and technical services. Effective
March 30, 2004, I-Contact has agreed to amend the agreement and waived all financial obligations and committed seats requirement over the two-year period. iPlus will pay all its remaining obligations pertaining only to the 300 seats delivered by I-Contact. In June 2005, iPlus committed to purchase additional 50 predictive dialer and Cosmocorder licenses in the amount of
Php18 million.

Other Long-term Obligations

Mandatory Conversion and Purchase of Shares. As discussed in *Note 9 Investments in Associates* and *Note 17 Interest-bearing Financial Liabilities*, as at June 30, 2005 PLDT had issued a total of 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for a total of 58 million shares of Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel adopted in June 2004.

Each share of Series V, VI and VII Convertible Preferred Stock is convertible at any time at the option of the holder into one PLDT common share. On the date immediately following the seventh anniversary of the issue date of the

Series V and Series VI Convertible Preferred Stocks and on the eighth anniversary of the issue date of the Series VII Convertible Preferred Stock, the remaining outstanding shares under these series will be mandatorily converted to PLDT common shares. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion of the Series V, VI and VII Convertible Preferred Stock will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JP¥4,071.89 per share, respectively.

As at June 30, 2005, 1,435,905 shares of Series V Convertible Preferred Stock and 604,449 shares of Series VI Convertible Preferred Stock had been converted to PLDT common shares. The aggregate value of the put option based on outstanding shares as at June 30, 2005 was
Php19,633 million, of which Php11,706 million is payable on June 4, 2008 and Php7,927 million on June 4, 2009, if all of the outstanding shares of Series V, VI and VII Convertible Preferred Stocks were mandatorily converted and all the underlying shares of common stock were put to PLDT. As at June 30, 2005, 1,285,535 shares of Series V, 4,690,655 shares of Series VI and 3,842,000 shares of Series VII Convertible Preferred Stock remain outstanding. The market value of the underlying shares of common stock was Php13,549 million, based on the market price of PLDT common shares of Php1,620 per share as at June 30, 2005.

Please refer to *Note 17 Interest-bearing Financial Liabilities* to the accompanying unaudited consolidated financial statements for further discussion.

Commercial Commitments

As at June 30, 2005, our outstanding commercial commitments, in the form of letters of credit, amounted to Php947 million. These commitments will expire within one year.

Quantitative and Qualitative Disclosures about Market Risks

Our operations are exposed to various risks, including liquidity risk, foreign exchange risk and interest rate risk. The importance of managing these risks has significantly increased in light of considerable change and continuing volatility in the Philippine and international financial markets. With a view to managing these risks, we have incorporated financial risk management functions in our organization, particularly in our treasury operations.

Liquidity Risk Management

We seek to manage our liquidity profile to be able to finance our capital expenditures and service our maturing debts. To cover our financing requirements, we intend to use internally generated funds and proceeds from debt and equity issues and sales of certain assets.

As part of our liquidity risk management program, we regularly evaluate our projected and actual cash flow information and continuously assess conditions in the financial markets for opportunities to pursue fund-raising initiatives. These initiatives may include bank loans, export credit agency-guaranteed facilities, and debt capital and equity market issues.

Foreign Exchange Risk Management

As at June 30, 2005, the Philippine peso had appreciated against the U.S. dollar to Php56.177 to US$1.00 from Php56.341 to US$1.00 as at December 31, 2004. As at June 30, 2004, on the other hand, the peso depreciated by 1% to Php56.176 to US$1.00 from Php55.586 to US$1.00 as at December 31, 2003. As at June 30, 2005, the Philippine peso had appreciated by 8% against the Japanese yen to Php0.5067 to JP¥1 from Php0.5495 to JP¥1 as at December 31, 2004. Likewise, as at June 30, 2004, the peso appreciated by approximately 1% to Php0.5166 to JP¥1 from Php0.5193 to JP¥1 as at December 31, 2003. As such, we recognized foreign exchange gains of Php1,530 million in the first half of 2005 as compared to foreign exchange losses of
Php1,452 million recorded in the same period in 2004.

While a certain percentage of our revenues is either linked to or denominated in U.S. dollars, substantially all of our indebtedness, a substantial portion of our capital expenditures and a portion of our operating expenses are denominated in foreign currencies, mostly in U.S. dollars.

As at June 30, 2005, approximately 98% of our total consolidated debts were denominated in foreign currencies. Of our foreign currency-denominated debts, 4% are in Japanese yen on a consolidated basis and the balance in U.S. dollars. Thus, a weakening of the peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 62% of our consolidated debts), and interest expense on our debt in peso terms. In addition, many of our financial ratios and other financial tests will be negatively affected. If, among other things, the value of the peso against the U.S. dollar substantially drops from its current level, we may be unable to maintain compliance with these ratios, which could result in acceleration of some or all of our indebtedness. For further information on our loan covenants, see Liquidity and Capital Resources Financing Activities Covenants above and *Note 17 Interest-bearing Financial Liabilities* to the accompanying unaudited consolidated financial statements.

To manage our foreign exchange risks, stabilize cash flows, and improve investment and cash flow planning, we enter into forward foreign exchange contracts, foreign currency swap contracts, currency options and other hedging products aimed at reducing and/or managing the adverse impact of changes in foreign exchange rates on our operating results and cash flows. However, these hedges do not cover all of our exposure to foreign exchange risks.

Specifically, we use forward foreign exchange contracts, foreign currency swap contracts and currency option contracts to manage the foreign exchange risk associated with our foreign currency-denominated loans. In order to manage hedge costs of these contracts, we utilize structures that include credit-linkage with PLDT as the reference entity, combination of currency option contracts, and fixed to floating coupon only swap agreements. Accounted as either cash flow hedges or transactions not designated as hedges, changes in the fair value of these instruments are recognized as cumulative translation adjustments in equity until the hedged item is recognized in earnings or directly to income for the period. As at June 30, 2005, PLDT s outstanding forward foreign exchange contracts, principal-only long-term cross-currency swap contracts and currency option contracts amounted to US$87 million and JP¥879 million; US$550 million; and
US$263 million, respectively. Smart s has no outstanding forward foreign exchange contracts as at June 30, 2005.

For further discussions of these contracts, see *Note 24 Financial Assets and Liabilities Derivative Financial Instruments* to the accompanying unaudited consolidated financial statements.

Interest Rate Risk Management

On a limited basis, we enter into interest rate swap agreements in order to manage our exposure to interest rate fluctuations. As at June 30, 2005, PLDT s outstanding interest rate swap contracts amounted to US$125 million. For further discussions of these contracts, see *Note 24 Financial Assets and Liabilities Derivative Financial Instruments* to the accompanying unaudited consolidated financial statements.

We make use of hedging instruments and structures solely for reducing or eliminating financial risks associated with our liabilities and not for trading or speculative purposes.

Impact of Inflation and Changing Prices

Inflation can be a significant factor in the Philippine economy, and we are continually seeking ways to minimize its impact. In recent periods, while decreases in the relative value of the peso have had a significant effect on us, we do not believe inflation has had a material impact on our operations. The average inflation rate in the Philippines in the first half of 2005 was 7.1%, compared to 5.1% in the same period in 2004.

OTHER INFORMATION

Related Party Transactions

In the ordinary course of business, a number of companies related to but outside of the consolidated PLDT Group are engaged in arm s-length intercompany transactions. We believe that the terms of these transactions are comparable with those available from unrelated parties.

Transactions to which PLDT or its subsidiaries is a party, in which a director or key officer or owner of more than 10% of the common shares of PLDT, or any member of the immediate family of a director or key officer or owner of more than 10% of the common shares of PLDT had a direct or indirect material interest in PLDT or its subsidiaries, as at June 30, 2005 and December 31, 2004 and for the six months ended June 30, 2005 and 2004 are as follows:

Agreements with NTT Communications and/or its Affiliates agreements under which (1) NTT Communications provides advisory services for various business areas of PLDT; (2) NTT World Engineering Marine Corporation provides maintenance services to PLDT s DFON; (3) PLDT is licensed to market managed data and other services using NTT Communications Arcstar brand; and (4) PLDT and NTT Communications agreed to cooperative arrangements for conventional international telecommunication services. Total fees under these agreements totaled Php114 million and Php146 million for the six months ended June 30, 2005 and 2004, respectively. PLDT s outstanding obligations under these agreements amounted to Php55 million and Php49 million as at June 30, 2005 and December 31, 2004, respectively.

Agreements between Smart and Asia Link B.V. agreements under which Asia Link undertakes to provide technical support services and assistance in the operations and maintenance of Smart s cellular business. Total fees under these agreements totaled Php278 million and Php239 million for the six months ended June 30, 2005 and 2004, respectively. Under these agreements, Smart had outstanding payables of Php284 million and Php267 million as at June 30, 2005 and December 31, 2004, respectively. Asia Link is a subsidiary of the First Pacific Group.

Agreements relating to insurance companies Gotuaco del Rosario and Associates, or Gotuaco, acts as the broker for certain insurance companies to cover certain insurable properties of the PLDT Group. Insurance premiums are remitted to Gotuaco and the broker s fees are settled between Gotuaco and the insurance companies. In addition, PLDT has an insurance policy with Malayan Insurance Co., Inc., or Malayan, wherein premiums are directly paid to Malayan. Total insurance expenses paid under these agreements amounted to Php268 million and Php238 for the six months ended June 30, 2005 and 2004, respectively. Two directors of PLDT have direct/indirect interests in or serve as a director/officer of Gotuaco and Malayan.

For a more detailed discussion of the related party transactions enumerated above, see *Note 20 Related Party Transactions* to the accompanying unaudited consolidated financial statements.

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PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS AT JUNE 30, 2005 (UNAUDITED) AND DECEMBER 31, 2004 (AUDITED)

AND FOR THE SIX MONTHS ENDED JUNE 30, 2005 AND 2004 (UNAUDITED)

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in million pesos, except par value amounts)

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
ASSETS		
Noncurrent Assets		
Property, plant and equipment (Notes 2, 8 and 17)	**190,176**	194,525
Investments in associates (Notes 2, 9 and 17)	**12**	8
Investments-available-for-sale (Notes 2 and 24)	**109**	104
Investment properties (Notes 2 and 10)	**732**	743
Goodwill and intangible assets (Notes 2, 3 and 11)	**3,727**	3,864
Deferred income tax assets (Notes 2 and 6)	**12,291**	12,738
Derivative assets (Notes 2 and 24)	**3,694**	4,116
Notes receivable (notes 2, 12 and 24)	**346**	286
Prepayments (Note 17)	**1,207**	997
Other noncurrent assets (Note 2)	**1,063**	1,237
Total Noncurrent Assets	**213,357**	218,618
Current Assets		
Cash and cash equivalents (Notes 2, 13 and 24)	**35,629**	27,321
Short-term investments (Notes 2 and 24)	**27**	3,873
Trade and other receivables (Notes 2, 14 and 24)	**8,457**	10,404
Inventories and supplies (Notes 2 and 15)	**2,255**	2,140
Derivative assets (Notes 2 and 24)	**217**	335
Prepayments (Note 17)	**1,474**	1,271
Other current assets (Notes 2 and 20)	**1,773**	1,511
Total Current Assets	**49,832**	46,855
	263,189	265,473
EQUITY AND LIABILITIES		
Equity (Notes 2, 7 and 16)		
Preferred stock, Php10 par value, authorized 822,500,000 shares; issued and outstanding 448,708,863 as at June 30, 2005 and 449,682,057 shares as at December 31, 2004	**4,487**	4,497
Common stock, Php5 par value, authorized 234,000,000 shares; issued and outstanding 171,363,153 as at June 30, 2005 and 170,213,722 shares as at December 31, 2004	**857**	851
Stock options issued (Note 21)	**124**	181
Equity portion of convertible preferred stock (Note 17)	**1,264**	1,459
Capital in excess of par value	**51,941**	50,528
Deficit (Note 7)	**(117)**	(10,220)

Cumulative translation adjustments (Note 24)	**(134)**	362
Total Equity Attributable to Equity Holders	**58,422**	47,658
Minority interest	**882**	857
Total Equity	**59,304**	48,515

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (*continued*)

(in million pesos, except par value amounts)

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
Noncurrent Liabilities		
Interest-bearing financial liabilities - net of current portion (Notes 2, 8, 17, 22 and 24)	**116,802**	135,988
Deferred income tax liabilities (Notes 2 and 6)	**1,955**	1,943
Derivative liabilities (Notes 2 and 24)	**4,755**	5,903
Provision for onerous contracts and assessments - net of current portion (Notes 20, 22 and 23)	**4,068**	3,951
Pension and other benefits (Notes 2 and 21)	**3,702**	2,908
Customers deposits	**2,142**	2,174
Other noncurrent liabilities (Notes 2, 8, 14 and 18)	**8,641**	7,159
Total Noncurrent Liabilities	**142,065**	160,026
Current Liabilities		
Accounts payable (Notes 2 and 24)	**5,300**	7,029
Accrued expenses and other current liabilities (Notes 2, 17, 19, 20, 24 and 25)	**16,104**	14,811
Unearned revenues (Note 2)	**2,639**	2,892
Derivative liabilities (Notes 2 and 24)	**229**	474
Current portion of provision for onerous contracts and assessments (Notes 20 and 23)	**699**	597
Current portion of interest-bearing financial liabilities (Notes 2, 8, 17, 22 and 24)	**29,463**	28,501
Dividends payable (Notes 2, 7, 17 and 24)	**4,366**	652
Income tax payable (Notes 2 and 6)	**3,020**	1,976
Total Current Liabilities	**61,820**	56,932
	263,189	265,473

See accompanying Notes to Unaudited Consolidated Financial Statements.

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(in million pesos, except per share amounts)

	Six Months Ended June 30,		Three Months Ended June 30,	
	2005	2004	**2005**	2004
	(Unaudited)			
INCOME (Notes 2 and 4)				
Service revenues	**59,522**	57,841	**30,161**	29,734
Non-service revenues (Note 5)	**1,422**	4,311	**607**	1,680
Other income	**194**	147	**119**	62
	61,138	62,299	**30,887**	31,476
EXPENSES (Notes 2 and 4)				
Depreciation and amortization (Note 8)	**10,861**	10,927	**5,305**	5,590
Compensation and benefits (Notes 5 and 21)	**6,492**	5,996	**3,406**	3,012
Financing costs (Note 5)	**4,349**	9,901	**4,282**	5,483
Maintenance (Note 20)	**3,320**	2,776	**1,776**	1,465
Cost of sales (Notes 5, 20 and 22)	**3,271**	6,599	**1,267**	2,730
Selling and promotions	**2,770**	2,386	**1,318**	1,261
Provisions (Notes 5, 14, 15, 20 and 22)	**1,968**	2,176	**1,369**	840
Professional and other service fees (Note 20)	**1,043**	1,005	**629**	565
Taxes and licenses (Note 23)	**1,034**	771	**460**	384
Rent	**954**	1,060	**324**	511
Insurance and security services (Note 20)	**825**	810	**414**	412
Asset impairment (Notes 8 and 9)		85		
Other expenses (Notes 5 and 20)	**1,740**	1,548	**752**	681
	38,627	46,040	**21,302**	22,934
INCOME BEFORE INCOME TAX	**22,511**	16,259	**9,585**	8,542
PROVISION FOR INCOME TAX (Notes 2 and 6)	**5,694**	3,811	**2,151**	1,775
NET INCOME FOR THE PERIOD	**16,817**	12,448	**7,434**	6,767
ATTRIBUTABLE TO:				
Equity holders	**16,785**	12,423	**7,424**	6,737
Minority interest	**32**	25	**10**	30
	16,817	12,448	**7,434**	6,767
Earnings Per Common Share (Note 7)				
Basic	**94.00**	68.78	**41.22**	37.48
Diluted	**88.83**	68.00	**41.22**	36.70

See accompanying Notes to Unaudited Consolidated Financial Statements.

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(in million pesos)

	Preferred Stock	Common Stock	Stock Options Issued	Equity Portion of Convertible Preferred Stock	Capital in Excess of Par Value	Retained Earnings (Deficit)	Cumulative Translation Adjustments	Equity Attributable to Equity Holders of PLDT	Minority Interest	Total Equity
					(Unaudited)					
Balances at January 1, 2004 (As restated)	4,505	847	286	1,536	49,690	(36,736)	549	20,677	771	21,448
Changes in equity:										
Net income for the period										
As previously reported						12,008		12,008	18	12,026
Effect of changes in accounting policies (Note 2)						415		415	7	422
As restated						12,423		12,423	25	12,448
Cash dividends						(708)		(708)		(708)
Currency translation differences (Note 24)							13	13		13
Issuance of capital stock - net (Note 16)	(5)				9			4		4
Exercised shares		1	(27)		91			65		65
Cancelled option shares (Note 21)			(5)		5					
Cost of share-based payments			7					7		7
Minority interest									48	48
Balances at June 30, 2004 (As restated Note 2)	4,500	848	261	1,536	49,795	(25,021)	562	32,481	844	33,325

Balances at January 1, 2005	4,497	851	181	1,459	50,528	(10,220)	362	47,658	857	48,515
Changes in equity:										
Net income for the period						16,785		16,785	32	16,817
Cash dividends						(6,682)		(6,682)		(6,682)
Currency translation differences (Note 24)							(2)	(2)		(2)
Net gains on available-for-sale financial assets (Note 24)							6	6		6
Net loss on cash flow hedges (Note 24)							(500)	(500)		(500)
Issuance of capital stock - net (Note 16)	(10)	5		(195)	1,226			1,026		1,026
Exercised shares		1	(57)		187			131		131
Minority interest									(7)	(7)
Balances at June 30, 2005 (Unaudited)	4,487	857	124	1,264	51,941	(117)	(134)	58,422	882	59,304

See accompanying Notes to Unaudited Consolidated Financial Statements.

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in million pesos)

	Six Months Ended June 30,	
	2005	2004
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Income before income tax	**22,511**	16,259
Adjustments for:		
Depreciation and amortization	**10,861**	10,927
Interest on loans and related items - net of capitalized interest (Note 5)	**5,453**	6,201
Provision for doubtful accounts (Note 5)	**1,526**	1,875
Accretion on financial liabilities - net (Note 5)	**1,437**	1,496
Write-down of inventories at net realizable value (Note 5)	**325**	128
Dividends on preferred stock subject to mandatory redemption (Note 5)	**132**	117
Provision for onerous contracts (Note 5)	**117**	173
Equity in net losses (income) of associates (Note 5)	**(3)**	36
Interest income (Note 5)	**(741)**	(468)
Foreign exchange (gains) losses - net	**(1,376)**	1,397
Loss (gain) on derivative transactions - net (Note 5)	**(1,719)**	604
Asset impairment		85
Others	**201**	307
Operating income before working capital changes	**38,724**	39,137
Decrease (increase) in:		
Trade and other receivables	**466**	(510)
Inventories and supplies	**(463)**	(624)
Prepayments	**(554)**	17
Other current assets	**(260)**	59
Increase (decrease) in:		
Accounts payable	**(1,872)**	3,677
Accrued expenses and other current liabilities	**1,907**	(446)
Unearned revenues	**(252)**	(279)
Pension and other benefits	**794**	(819)
Net cash generated from operations	**38,490**	40,212
Income taxes paid	**(3,871)**	(2,132)
Net cash provided by operating activities	**34,619**	38,080
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to property, plant and equipment	**(6,809)**	(11,273)
Proceeds from disposal of property, plant and equipment	**300**	22
Interest paid - capitalized to property, plant and equipment (Note 5)	**(203)**	(302)
Payments for purchase of investments	**(238)**	(147)

Additions to investment properties		(2)
Payments for purchase of investments-available-for-sale	**(4)**	(3)
Decrease (increase) in short-term investments	**3,847**	(1,937)
Investments in notes receivable	**(60)**	
Interest received	**747**	468
Decrease in other noncurrent assets	**200**	(261)
Net cash used in investing activities	**(2,220)**	(13,435)

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (*continued*)

(in million pesos)

	Six Months Ended June 30,	
	2005	2004
	(Unaudited)	
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from long-term debt	**5,471**	4,824
Payments of long-term debt	**(22,187)**	(17,436)
Proceeds from notes payable	**251**	45
Payments of notes payable	**(254)**	(2,045)
Payments of obligations under capital lease	**(43)**	(14)
Interest paid - net of capitalized portion	**(5,671)**	(6,339)
Cash dividends paid	**(2,963)**	(601)
Proceeds from issuance of capital stock	**133**	68
Payments of debt issuance costs	**(133)**	(21)
Increase (decrease) in:		
Customers deposits	**(30)**	22
Other noncurrent liabilities	**1,430**	346
Net cash used in financing activities	**(23,996)**	(21,151)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	**(95)**	(67)
NET INCREASE IN CASH AND CASH EQUIVALENTS	**8,308**	3,427
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	**27,321**	19,372
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**35,629**	22,799

See accompanying Notes to Unaudited Consolidated Financial Statements.

PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Corporate Information

The Philippine Long Distance Telephone Company, or PLDT, or Parent Company, was incorporated under the old Corporation Law of the Philippines (Act 1459, as amended) on November 28, 1928, following the merger of four telephone companies under common United States ownership. Under its amended Articles of Incorporation, PLDT s corporate term is limited through 2028. In 1967, effective control of PLDT was sold by General Telephone and Electronics Corporation (a major shareholder since PLDT s incorporation) to a group of Filipino businessmen. In 1981, in furtherance of the then existing policy of the Philippine government to integrate the Philippine telecommunications industry, PLDT purchased substantially all of the assets and liabilities of the Republic Telephone Company which at that time was the second largest telephone company in the Philippines. During 1998, First Pacific through its Philippine and other affiliates, acquired a significant interest in PLDT. On March 24, 2000, NTT Communications Corporation, through NTTC-UK, became PLDT s strategic partner with approximately 15% economic and voting interest in the issued common capital stock of PLDT. Simultaneous with NTT Communications Corporations investment in PLDT, we acquired 100% of Smart Communications, Inc., or Smart.

The common shares of PLDT are listed and traded on the Philippine Stock Exchange, or PSE, and prior to October 19, 1994, were listed and traded on the American Stock Exchange and Archipelago Exchange in the United States. On October 19, 1994, an American Depositary Receipts, or ADRs, facility was established, pursuant to which Citibank N.A., as the depositary, issued ADRs evidencing American Depositary Shares, or ADSs, with each ADS representing one PLDT common share with a par value of Php5 per share. JP Morgan Chase Bank has been appointed as successor depositary for PLDT s ADRs effective February 10, 2003. The ADSs are listed and traded on the New York Stock Exchange and the Archipelago Exchange in the United States.

PLDT s charter, like those of all other Philippine corporations, was initially limited to a period of 50 years but has since been extended twice for 25 years each, the last extension being for an additional

25-year period to 2028. Under its amended charter (Republic Act No. 7082), which became effective on August 24, 1991, PLDT is authorized to provide virtually every type of telecommunications service, both within the Philippines and between the Philippines and other countries.

PLDT operates under the jurisdiction of the Philippine National Telecommunications Commission, or NTC, which jurisdiction extends, among other things, to approving major services offered by PLDT and certain rates charged by PLDT.

The registered office address of PLDT is Ramon Cojuangco Building, Makati Avenue, Makati City, Philippines.

2. Summary of Significant Accounting Policies and Practices

Basis of Preparation

Our unaudited consolidated financial statements have been prepared in conformity with Philippine Generally Accepted Accounting Principles, or Philippine GAAP, under the historical cost convention as modified by the revaluation of derivative financial instruments, available-for-sale financial assets and investment properties that are measured at fair value. The carrying values of recognized assets and liabilities that are hedged are adjusted to record changes in the fair values attributable to the risks that are being hedged.

Our unaudited consolidated financial statements include, in our opinion, all adjustments consisting only of normal recurring adjustments, necessary to present fairly the results of operations for the interim periods. The results of operations for the six months ended June 30, 2005 are not necessarily indicative of the results of operations that may be expected for the full year.

Our unaudited consolidated financial statements are presented in Philippine pesos and all values are rounded to the nearest million except when otherwise indicated.

Changes in Accounting Policies

In recent years, the Philippine Accounting Standards Committee, or ASC, has been adopting the International Accounting Standards, or IAS, issued by the International Accounting Standards Committee, or IASC, with no local equivalent standards and has been replacing existing local standards.

The International Accounting Standards Board, or IASB, has assumed from the IASC the responsibility for setting IAS. The standards issued by the IASB are designated as International Financial Reporting Standards, or IFRS. Upon its adoption, the IASB also adopted the IAS issued by the IASC. The IASB carried on improvements in certain IAS in preparation for the full adoption of IFRS effective January 1, 2005.

The ASC has re-named the new standards Philippine Accounting Standards , or PAS, and Philippine Financial Reporting Standards , or PFRS, to correspond with the adopted IAS and IFRS of the IASB. ASC standards were previously designated as Statements of Financial Accounting Standards , or SFAS.

The accounting policies adopted are consistent with those of the previous financial period except that we have adopted in year-end 2004 the following new accounting standards intended to be mandatory beginning January 1, 2005. Our June 30, 2004 unaudited consolidated financial statements herein have been restated to give effect to the provisions of the new standards adopted.

PAS 19, Employee Benefits . PAS 19 requires the use of the projected unit credit method in measuring retirement benefit expense and a change in the manner of computing benefit expense relating to past service cost and actuarial gains and losses. Past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. On the initial adoption of this standard, the effect of the change in accounting policy includes all actuarial gains and losses that arose in earlier periods even if they fall inside the 10% corridor. In subsequent periods, portion of actuarial gains or losses is recognized as income or expense if the cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceed the greater of: (i) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and (ii) 10% of the fair value of any planned assets at that date by dividing the excess determined by the expected average remaining working lives of the employees participating in that plan is recognized immediately as income or expense. Our adoption of this standard reduced our consolidated net income by Php20 million (Php15 million after tax effect) for the six months ended June 30, 2004.

PAS 21, The Effects of Changes in Foreign Exchange Rates . PAS 21 requires the recognition of foreign exchange gains and losses in the period they are incurred. Upon the adoption of PAS 21, we adjusted previously recorded undepreciated capitalized foreign exchange losses, net of exchange losses that qualify as borrowing cost and income tax effect, against beginning retained earnings, to the extent that such capitalized amounts do not meet the conditions for capitalization under the new accounting standard, and restated prior periods unaudited consolidated financial statements. Further, PAS 21 requires the determination of the functional currency of an entity. Exchange differences from any retranslation are taken directly as a separate component of equity. On disposal of an entity with a functional currency other than the Philippine peso, the deferred cumulative amount recognized in equity relating to that particular foreign operation shall be recognized in the consolidated statement of income. Our adoption of this standard increased our consolidated net income by Php1,779 million (Php1,226 million after tax effect) for the six months ended June 30, 2004.

PAS 27, Consolidated and Separate Financial Statements . PAS 27 supersedes SFAS 27/IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries . Under PAS 27, the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that significantly impair a subsidiary s ability to transfer funds to the parent company under the superseded standard was removed. Consequently, Pilipino Telephone Corporation, or Piltel, was required to be included in our unaudited consolidated financial statements retrospectively. Our adoption of this standard increased our consolidated net income by Php840 million for the six months ended June 30, 2004.

PAS 32, Financial Instruments: Disclosure and Presentation . PAS 32 covers the disclosure and presentation of all financial instruments. This standard requires more comprehensive disclosures about a company s financial instruments, whether recognized or unrecognized in the financial statements. New disclosure requirements include terms and conditions of financial instruments used, types of risks associated with both recognized and unrecognized financial instruments (market risk, price risk, credit risk, liquidity risk, and cash flow risk), fair value information of both recognized and unrecognized financial assets and financial liabilities, and our financial risk management policies and objectives. This standard also requires financial instruments to be classified as liabilities or equity in accordance with their substance and not their legal form. Consequently, we have designated PLDT s Convertible Preferred Stock Series V, VI and VII as compound instruments consisting of liability and equity components. The total fair value of the Convertible Preferred Stock Series V, VI and VII was determined at issue date, of which the aggregate fair value of the liability component of the Series V, VI and VII Convertible Preferred Stock as at issuance date is included as a financial liability under *Interest-bearing Financial Liabilities* account in the unaudited consolidated balance sheets. The residual amount was assigned as the equity component. Our adoption of this standard reduced our consolidated net income by Php897 million (Php647 million after tax effect) for the six months ended June 30, 2004.

PAS 39, Financial Instruments: Recognition and Measurement . PAS 39 establishes the accounting and reporting standards for recognizing and measuring our financial assets and financial liabilities. This standard requires a financial asset or financial liability to be recognized initially at fair value. Subsequent to initial recognition, we are to continue to measure financial assets at their fair values, except for loans and receivables and held-to-maturity investments, which are measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as at fair value through profit and loss and derivatives, which are measured at fair value.

PAS 39 also covers the accounting for derivative instruments. This standard has expanded the definition of a derivative instrument to include derivatives (derivative-like provisions) embedded in non-derivative contracts. Under this standard, every derivative instrument is recorded in the balance sheet as either an asset or liability measured at its fair value. Derivatives that are not designated and do not qualify as hedges are adjusted to fair value through income. If the derivative is designated and qualifies as a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in equity until the hedged item is recognized in earnings.

Our adoption of this standard decreased our consolidated net income by Php1,277 million (Php830 million after tax effect) for the six months ended June 30, 2004.

***PAS 40, Investment Property*.** PAS 40 prescribes the accounting treatment for investment properties which are defined as land and/or building held to generate income or for capital appreciation or both. An investment property is initially recognized at cost. Subsequent to initial recognition, an investment property is either carried at (i) cost, less accumulated depreciation or any accumulated impairment losses, or (ii) fair value, wherein fair value movements are recognized as income or expense. Transfers to or from investment property classification are made only when there is evidence of a change in use.

Our adoption of this standard, where we opted to carry our investment properties at fair value subsequent to initial recognition, decreased our consolidated net income by Php10 million (Php7 million after tax effect) for the six months ended June 30, 2004.

***PFRS 2, Share-Based Payment*.** PFRS 2 requires an entity to recognize goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. In line with our adoption of PFRS 2, we recognized in our consolidated statements of income the costs of employees and directors share options and other share-based incentives by using an option-pricing model, further details of which are given in *Note 21 Employee Benefits*.

Our adoption of this standard decreased our consolidated net income by Php127 million (Php93 million after tax effect) for the six months ended June 30, 2004.

***PFRS 3, Business Combinations, PAS 36, Impairment of Assets and PAS 38, Intangible Assets*.** PFRS 3 requires all business combinations within its scope to be accounted for by applying the purchase method. In addition, this standard requires the acquirer to initially measure separately the identifiable assets, liabilities and contingent liabilities at their fair values, at acquisition date, irrespective of the extent of any minority interest.

PFRS 3 also requires goodwill in a business combination to be recognized by an acquirer as an asset from the acquisition date, initially measured as the excess of the cost of the business combination over the acquirer s interest in the net fair value of the acquiree s identifiable assets and liabilities. Further, the amortization of goodwill acquired in a business combination is prohibited; instead, goodwill is to be tested annually, or more frequently, if events or changes in circumstances indicate that the asset might be impaired.

Moreover, the useful lives of intangible assets are assessed at the individual asset level as having either a finite or indefinite life. Where an intangible asset has a finite life, it will be amortized over its useful life. Amortization periods and methods for intangible assets with finite useful lives are reviewed annually or earlier where an indicator of impairment exists. Intangibles assessed as having indefinite useful lives are not amortized, as there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the PLDT Group. However, intangibles with indefinite useful lives are reviewed annually to ensure that their carrying values do not exceed the recoverable amounts regardless of any impairment indicators present.

Our adoption of this standard decreased our consolidated net income by Php26 million for the six months ended June 30, 2004.

PFRS 5, Noncurrent Assets Held-for-Sale and Discontinued Operations**.** Under the superseded SFAS 35/IAS 35, *Discontinuing Operations*, we would have previously recognized a discontinued operation at the earlier of when (a) we enter into a binding agreement; and (b) the Board of Directors have approved and announced a formal disposal plan. PFRS 5 now requires an operation to be classified as discontinued when the criteria to be classified as held-for-sale have been met or we have disposed of the operation.

In addition to these standards referred to above, we have adopted the following standards during the period and comparative figures have been amended as required:

- PAS 1 Presentation of Financial Statements ;
- PAS 2 Inventories ;
- PAS 8 Accounting Policies, Changes in Accounting Estimates and Errors ;
- PAS 10 Events After the Balance Sheet Date ;
- PAS 24 Related Party Disclosures ;
- PAS 28 Investments in Associates ;
- PAS 31 Interests in Joint Ventures ; and
- PAS 33 Earnings Per Share .

Following additional guidelines from PAS 16, Property, Plant and Equipment , we have recognized the initial settlement of the net present value of legal and constructive obligations associated with the retirement of a tangible long-lived asset that resulted from the acquisition, construction or development and the normal operation of a long-lived asset in the period in which it is incurred. The asset retirement obligations were recognized in the period in which they are incurred if a reasonable estimate of fair values can be made. The related asset retirement costs are capitalized as part of the carrying amount of the corresponding property, plant and equipment which are being depreciated on a straight-line basis over the useful lives of the related assets or the contract periods, whichever is lower.

We are legally required under various lease agreements to dismantle the installations and restore the leased sites to their original state at the end of the lease contract term. Our adoption of certain provisions of this standard reduced our consolidated net income by Php50 million (Php34 million after tax effect) for the six months ended June 30, 2004.

Adoption of the above standards involved changes in accounting policies and we have accordingly restated our comparative unaudited consolidated financial statements retroactively in accordance with the transitional provisions in these standards. Reconciliation of the effects of these new standards, as they apply to us, on our net income for the six months ended June 30, 2004 is set out below.

		(in millions, except per share amounts)
Net income, as previously reported		Php12,008
PAS 16	Property, Plant and Equipment	(34)
PAS 17	Leases	1
PAS 19	Employee Benefits	(15)
PAS 21	The Effects of Changes in Foreign Exchange Rates	1,226
PAS 27	Consolidated and Separate Financial Statements	840
PAS 32	Financial Instruments: Disclosure and Presentation	(647)
PAS 39	Financial Instruments: Recognition and Measurement	(830)
PAS 40	Investment Property	(7)
PFRS 2	Share-Based Payment	(93)
PFRS 3	Business Combinations, PAS 36 Impairment of Assets and	
PAS 38	Intangible Assets	(26)
Net income, as restated		Php12,423
Earnings per common share, as previously reported		Php65.62
Earnings per share impact of restated items:		
PAS 16	Property, Plant and Equipment	(0.20)
PAS 17	Leases	0.01
PAS 19	Employee Benefits	(0.09)
PAS 21	The Effects of Changes in Foreign Exchange Rates	7.17
PAS 27	Consolidated and Separate Financial Statements	4.95
PAS 32	Financial Instruments: Disclosure and Presentation	(3.04)
PAS 39	Financial Instruments: Recognition and Measurement	(4.90)
PAS 40	Investment Property	(0.04)
PFRS 2	Share-Based Payment	(0.55)
PFRS 3	Business Combinations, PAS 36 Impairment of Assets and	
PAS 38	Intangible Assets	(0.15)
Earnings per common share, as restated		Php68.78

We fully adopted PAS 16 in 2005, which requires us to determine the depreciation charge separately for each significant part of an item of property, plant and equipment. Consequently, we changed the estimated useful lives of certain components of our property, plant and equipment and we recognized the effect of the change in accounting estimate prospectively, in accordance with PAS 8, Accounting Policies, Changes in Accounting Estimates and Errors . Our full adoption of this standard reduced our consolidated net income by Php698 million (Php475 million after tax effect) for the six months ended June 30, 2005.

Basis of Consolidation

Our unaudited consolidated financial statements include the financial statements of PLDT and those of the following subsidiaries (collectively, the PLDT Group), which were all incorporated in the Philippines except for PLDT Global Corporation, which was incorporated in the British Virgin Islands.

Name of Subsidiary	Principal Activity	Percentage of Ownership
Wireless		
Smart and subsidiaries	Cellular mobile services	100.0
Piltel and subsidiaries	Cellular mobile and telecommunications services	92.1
ACeS Philippines Cellular Satellite Corporation, or ACeS Philippines	Satellite phone services	100.0
Telesat, Inc., or Telesat	Satellite communications services	94.4
Mabuhay Satellite Corporation, or Mabuhay Satellite	Satellite communications services	67.0
Fixed Line		
PLDT Clark Telecom, Inc., or Clark Telecom	Telecommunications services	100.0
Subic Telecommunications Company, Inc., or Subic Telecom	Telecommunications services	100.0
PLDT Global Corporation, or PLDT Global, and subsidiaries	Telecommunications services	100.0
Smart-NTT Multimedia, Inc., or SNMI	Data and network services	100.0
PLDT-Maratel, Inc., or Maratel	Telecommunications services	97.5
Bonifacio Communications Corporation, or BCC	Telecommunications, infrastructure and related value-added services	75.0
Information and Communications Technology		
ePLDT, Inc., or ePLDT, and subsidiaries	Information and communications infrastructure for internet-based services, e-commerce, call centers and IT-related services	100.0

Subsidiaries are consolidated from the date when control is transferred to the PLDT Group and cease to be consolidated from the date when control is transferred out of the PLDT Group.

We prepare our unaudited consolidated financial statements using uniform accounting policies for like transactions and other events with similar circumstances. Intercompany balances and transactions, including intercompany profits and unrealized profits and losses, are eliminated.

Minority interests represent the equity interests in Telesat, Mabuhay Satellite, Maratel, BCC, Digital Paradise, Inc., or Digital Paradise, Digipar Thailand Ltd., netGames, Inc., or netGames, and Infocom Technologies, Inc. not held by the PLDT Group.

Changes in Piltel s Shareholding

To integrate the PLDT Group s wireless holdings, on July 2, 2004, Smart entered into a Sale and Purchase Agreement with PLDT to acquire PLDT s 59.3 million shares of Piltel Series K Class I Convertible Preferred Stock for a purchase price of Php2,066 million. The payment was settled through an offset of amounts owed to Smart by PLDT arising from interconnection charges. On July 9, 2004 and December 28, 2004, Smart converted a total of 4.8 million and 54.5 million shares, respectively, of Piltel Series K Class I Convertible Preferred Stock into 10,080 million shares of common stock of Piltel, equivalent to 85.6% of the resulting total outstanding shares of common stock after such conversion. On April 25, 2005, PLDT and Smart entered into a subscription and assignment agreement covering the transfer and assignment to Smart of 767 million shares of Piltel common stock owned by PLDT. As a result, Smart now owns 92.1% of the total outstanding common stock of Piltel, thereby consolidating the PLDT Group s wireless business under Smart. Transactions of entities under common control were accounted for at historical cost.

ePLDT Investments in ePLDT Ventus, Inc., or Ventus, and netGames

In the second half of 2004, ePLDT made investments in Ventus and netGames, which are newly incorporated companies.

Ventus is a wholly-owned call center subsidiary of ePLDT which was incorporated and registered with the Securities and Exchange Commission, or SEC, on October 5, 2004. ePLDT subscribed to 100 million shares at a total par value of Php100 million. Ventus which owns a 400-seat call center facility located in Iloilo province and commenced commercial operations in March 2005. Ventus will be expanding in Metro Manila with a 270-seat call center facility in Makati and a 640-seat call center facility in Ortigas, Pasig City to accommodate current and new client requirements. These facilities are expected to be completed by October 2005 and January 2006, respectively.

As at June 30, 2005, ePLDT owns 60% of netGames, a publisher for Massively Multi-player Online Game in the Philippines. netGames is the Philippine licensee of Khan Online, the country s first full 3D online game. netGames was incorporated on June 21, 2004 and commenced full commercial operations in February 2005. ePLDT sold 3% of its share in netGames in April 2005. In June 2005, ePLDT made an additional capital infusion amounting to Php11 million to netGames.

Acquisition of Meridian Telekoms, Inc. or Meridian

On July 5, 2004, Smart entered into a sale and purchase agreement, as amended and supplemented on August 11, 2004, to acquire 100% of Meridian, a company primarily engaged in providing wireless broadband and data services to small and medium-scale enterprises in the Philippines, for a total consideration of US$45 million. Payments of US$11 million and US$7 million for an equity interest of 40% in Meridian were made in 2004 and payments of US$4 million for an additional equity interest of 9% was made in January 2005. The balance of US$23 million is payable on or before December 31, 2005 in respect of the remaining 51% equity interest in Meridian. The acquisition aims to strengthen Smart s position in the wireless data segment and is in line with Smart s overall strategy of providing the widest range of innovative wireless services. As at June 30, 2005, the net cash outflow on acquisition was Php1,285 million, representing cash payments of Php1,242 million, cash acquired from Meridian of Php4 million and cost directly related to business combination of Php51 million.

Investments in Associates

Investments in associates in which we exercise significant influence and which are neither a subsidiary nor a joint venture of the PLDT Group are accounted for under the equity method of accounting. Under the equity method, our investments in associates are carried in the consolidated balance sheets at cost plus post-acquisition changes in our share in net assets of the investees, less impairment in value, if any. The consolidated statements of income reflect our share of the results of operations of the associates. Where there has been a change recognized directly in the associates equity, we recognize our share of any changes and disclose this, when applicable in the consolidated statements of changes in equity.

Foreign Currency Translation

The functional and presentation currency of the PLDT Group (except for Mabuhay Satellite) is the Philippine peso. Transactions in foreign currencies are initially recorded in the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the consolidated statements of income except for foreign exchange losses that qualified as capitalizable borrowing costs during construction period. For income tax purposes, exchange gains or losses are treated as taxable income or deductible expenses in the period such are realized.

The functional currency of Mabuhay Satellite is U.S. dollars. As at the reporting date, the assets and liabilities of this subsidiary are translated into the presentation currency of the PLDT Group at the rate of exchange ruling at the balance sheet date and, its income and expenses are translated at the weighted average exchange rate for the period. The exchange differences arising on retranslation are taken directly to a separate component of equity as cumulative translation adjustments. On disposal of this subsidiary, the deferred cumulative amount of translation adjustments recognized in equity relating to this particular subsidiary shall be recognized in the consolidated statements of income.

Property, Plant and Equipment

Property, plant and equipment, except for land, are stated at cost less accumulated depreciation and amortization and any impairment in value. Land is stated at cost less any impairment in value.

The initial cost of property, plant and equipment comprises its purchase price and any costs directly attributable in bringing the asset to its working condition and location for its intended use. Expenditures incurred after the assets have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to income in the period the costs are incurred. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard of performance, the expenditures are capitalized as additional costs of property, plant and equipment. Cost also includes asset retirement obligation, interest on borrowed funds used during the construction period and qualified borrowing costs from foreign exchange losses related to foreign currency-denominated liabilities used to acquire such assets. When assets are sold or retired, their costs and accumulated depreciation, amortization and impairment losses, if any, are eliminated from the accounts and any gain or loss resulting from their disposal is included in the consolidated statement of income of such period.

Depreciation and amortization are calculated on a straight-line basis over the following estimated useful lives of the assets:

-	**Estimated Useful Lives**
Buildings	25 years
Cable and wire facilities	20 25 years
Central office equipment	15 20 years
Information origination and termination equipment	5 15 years
Communications satellite	15 years
Vehicles and other work equipment	3 10 years
Furniture	3 10 years
Cellular facilities	10 years
Land improvements	10 years

The useful lives and depreciation and amortization method are reviewed periodically to ensure that the periods and method of depreciation and amortization are consistent with the expected pattern of economic benefits from items of property, plant and equipment.

Property under construction is stated at cost. This includes cost of construction, plant and equipment and other direct costs. Property under construction is not depreciated until such time that the relevant assets are completed and put into operational use.

Borrowing Costs

Borrowing costs are generally expensed as incurred. Borrowing costs are capitalized if they are directly attributable to the acquisition, construction or production of a qualifying asset. Capitalization of borrowing costs commences when the activities for use are in progress and expenditures and borrowing costs are being incurred. Borrowing costs are capitalized until the assets are ready for their intended use. If the resulting carrying amount of the asset exceeds its recoverable amount, an impairment loss is recognized. Borrowing costs include interest charges and other costs incurred in connection with the borrowing of funds, as well as exchange differences arising from foreign currency borrowings used to finance these projects to the extent that they are regarded as an adjustment to interest cost. Borrowing costs are treated as deductible expenses for income tax reporting purposes in the period they are incurred.

Asset Retirement Obligations

The net present value of legal obligations associated with the retirement of an item of property, plant and equipment that resulted from the acquisition, construction or development and the normal operation of property, plant and equipment is recognized in the period in which it is incurred.

Investment Properties

Initially, investment properties are measured at cost including transaction costs. Subsequent to initial recognition, investment properties are stated at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the consolidated statements of income in the period in which they arise.

Investment properties are derecognized when they have either been disposed of or when the investment property is permanently withdrawn from use and no future benefit is expected from its disposal. Any gains and losses on the derecognition of an investment property are recognized in the consolidated statement of income in the period of derecognition.

Goodwill

Goodwill is initially measured at cost being the excess of the acquisition cost over the fair value of identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Upon adoption of PFRS 3, goodwill is no longer amortized. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

As at acquisition date, any goodwill acquired is allocated to each of the cash-generating units expected to benefit from the combination s synergies. Impairment is determined by assessing the recoverable amount of the cash-generating unit, to which the goodwill relates. Where the recoverable amount of the cash-generating unit is less than the carrying amount, an impairment loss is recognized. Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in such circumstance is measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Intangible Assets

Intangible assets acquired separately are capitalized at cost while those acquired arising from business combinations are initially recognized at fair value as at the date of acquisition. Subsequently, intangible assets are measured at cost. The useful lives of intangible assets are now assessed at the individual asset level as having either a finite or indefinite life. Where an intangible asset has a finite life, it is amortized over its useful life. Periods and method of amortization for intangible assets with finite useful lives are reviewed annually or earlier where an indicator of impairment exists. Intangible assets assessed as having indefinite useful lives are not amortized, as there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the Group. However, intangibles with indefinite useful lives are reviewed annually to ensure the carrying value does not exceed the recoverable amount regardless of whether an indicator of impairment is present.

Gains or losses arising from derecognition of an intangible asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized in the consolidated statements of income when the asset is derecognized.

Intangible assets created within the business are not capitalized and expenditure is charged against profits in the period in which the expenditure is incurred.

Asset Impairment

Property, plant and equipment, investments, goodwill and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized in the consolidated statements of income. The recoverable amount is the higher of an asset s net selling price or value in use. The net selling price is the amount obtainable from the sale of an asset in an arm s length transaction while value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset or from its disposal at the end of its useful life. Recoverable amounts are estimated for individual assets or, if it is not possible, for the cash-generating unit to which the asset belongs. Reversal of impairment losses recognized in prior periods is recorded when there is an indication that the impairment losses recognized for the asset no longer exist or have decreased. The reversal is recorded as income. However, the increased carrying amount of an asset due to a reversal of an impairment loss is recognized to the extent it does not exceed the carrying amount that would have been determined had the impairment loss not been recognized for that asset in prior periods.

Cash and Cash Equivalents

Cash includes cash on hand and in banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less from the date of acquisition and that are subject to an insignificant risk of change in value.

Accounts Receivable

Accounts receivable are stated at face value, net of allowance for doubtful accounts.

Allowance for Doubtful Accounts

We estimate the allowance for doubtful accounts related to our trade receivables based on two methods. The amounts calculated using each of these methods are combined to determine the total amount we reserve. First, we evaluate specific accounts where we have information that certain customers are unable to meet their financial obligations. In these cases, we use judgment, based on the best available facts and circumstances, including but not limited to, the length of our relationship with the customer and the customer s current credit status based on third party credit reports and known market factors, to record specific reserves for customers against amounts due to reduce our receivable amounts that we expect to collect. These specific reserves are re-evaluated and adjusted as additional information received affects the amounts estimated. Second, a provision is established as a certain percentage of age of status of receivables. This percentage is based on a collective assessment of historical collection, write-off, experience and changes in our customer payment terms. Full allowance is provided for receivables from permanently disconnected subscribers. Partial allowance is provided for active subscribers and carriers based on the age status of receivables.

Inventories and Supplies

Inventories and supplies which include, among others, cellular phone units, materials, spare parts, terminal units and accessories, are valued at the lower of cost or net realizable value.

Cost is determined using the moving average method. Net realizable value is the current replacement cost.

Financial Assets and Liabilities

We recognize a financial asset or a financial liability in our consolidated balance sheets when we become a party to the contractual provisions of the instrument and derecognize a financial asset when we no longer control the contractual rights to the cash flows that comprise the financial instrument which is normally the case when the instrument is sold, or all the cash flows attributable to the instrument have already expired or are passed through to an independent third party. A financial liability (or a part of a financial liability) is derecognized when the obligation is extinguished. In the case of a regular way purchase or sale of financial assets, recognition and derecognition, as applicable, are done using settlement date accounting.

Financial assets or financial liabilities are recognized initially at fair value. Transaction costs are included in the initial measurement of all financial assets and liabilities, except for financial instruments measured at fair value through profit and loss. Fair value is determined by reference to the transaction price or other market prices. If such market prices are not reliably determinable, the fair value of the consideration is estimated as the sum of all future cash payments or receipts, discounted using the prevailing market rates of interest for similar instruments with similar maturities.

After initial recognition, the following financial assets and liabilities are measured at amortized cost using the effective interest rate method: (a) loans and receivables; (b) held-to-maturity investments;
and (c) financial liabilities other than liabilities measured at fair values through profit and loss.

Investments in unquoted equity securities and derivatives linked thereon are measured at cost.

Amortizations of discounts and premiums are taken directly to net profit or loss for the period. Changes in the fair value of financial assets and liabilities measured at fair value of (a) all derivatives (except for those eligible for hedge accounting); (b) other items intended to be actively traded; and (c) any item designated as held at fair value through profit and loss at origination, are taken directly to net profit or loss for the period. Changes in the fair value of available-for-sale securities are recognized in equity, except for the foreign exchange fluctuations on available-for-sale debt securities and the interest component which is taken directly to net profit or loss for the period based on the asset s effective yield.

Financial assets and liabilities include financial instruments which may be a primary instrument, such as receivables, payables and equity securities, or a derivative instrument, such as financial options, futures and forwards, interest rate swaps and currency swaps.

Financial instruments are classified as a financial liability, or a financial asset or an equity in accordance with the substance of the contractual arrangement. Financial instruments that contain both liability and equity elements are classified separately as financial liabilities, financial assets or equity instruments. Interest, dividends, gains and losses relating to a financial instrument or a component that is a financial liability, are reported as expense or income. Distributions to holders of financial instruments classified as equity are charged directly to equity net of any related income tax benefits. Financial instruments are offset when we have a legally enforceable right to offset and we intend to settle either on a net basis or to realize the asset and settle the liability simultaneously.

We use derivative financial instruments such as long-term currency swaps, foreign currency options, interest rate swaps and forward currency contracts to hedge our risks associated with foreign currency and interest rate fluctuations. Such derivative financial instruments are stated at fair value.

Our criteria for a derivative instrument to be classified as a hedge include: (1) the hedge transaction is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, (2) the effectiveness of the hedge can be reliably measured, (3) there is adequate documentation of the hedging relationships at the inception of the hedge, and (4) for cash flow hedges, the forecast transaction that is subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

For purposes of hedge accounting, hedges are classified as either fair value hedges where they hedge the exposure to changes in the fair value of a recognized asset or liability and firm commitment; or cash flow hedges where they hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognized asset or liability or a forecasted transaction.

In relation to fair value hedges which meet the conditions for special hedge accounting, any gain or loss from re-measuring the hedging instrument at fair value is recognized immediately in the consolidated statements of income. Any gain or loss on the hedged item attributable to the hedged risk is adjusted against the carrying amount of the hedged item and recognized in the consolidated statements of income.

In relation to cash flow hedges, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized directly in equity and the ineffective portion is recognized in net profit or loss. The gains or losses that are accumulated in equity are transferred to the consolidated statement of income in the same period in which the hedged item affects the net profit or loss.

For derivatives that do not qualify for hedge accounting, any gains or losses arising from changes in fair value are taken directly to net profit or loss for the period.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognized in equity is kept in equity until the forecast transaction occurs. If the forecast transaction is no longer expected to occur, any net cumulative gain or loss previously recognized in equity is transferred to net profit or loss for the period.

Provisions

We recognize provisions when we have obligations, legal or constructive, as a result of past events, if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as an additional provision.

Retirement Benefits

We have funded, noncontributory retirement plans, administered by our respective Fund s Trustees, covering permanent employees. Retirement costs are actuarially determined using the projected unit credit of accrued benefit valuation method. This method reflects services rendered by employees to the date of valuation and incorporates assumptions concerning employees projected salaries. Retirement costs include current service cost plus amortization of past service cost, experience adjustments and changes in actuarial assumptions. Past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. Actuarial gains and losses are recognized as income or expense when the net cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceeded 10% of the higher of the defined benefit obligation and the fair value of plan assets at that date. These gains and losses are recognized over the expected average remaining working lives of the employees participating in the plan.

Share-Based Payment Transactions

Certain of our employees (including directors) receive remuneration in the form of share-based payment transactions, whereby employees render services in exchange for shares or rights over shares (equity-settled transactions).

Equity-settled transactions

The cost of equity-settled transactions with employees is measured by reference to the fair value of the stock options at the date at which they are granted. Fair value is determined using an option-pricing model, further details of which are given in *Note 21 Employee Benefits*. In valuing equity-settled transactions, no account is taken of any performance conditions, other than conditions linked to the price of the shares of PLDT (market conditions).

The cost of equity-settled transactions is recognized, together with a corresponding increase in equity, over the period in which the performance conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award (vesting date). The cumulative expense recognized for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the number of awards that will ultimately vest, in the opinion of PLDT s Board of Directors at that date, based on the best available estimate.

No expense is recognized for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

Where the terms of an equity-settled award are modified, an expense, as a minimum, is recognized as if the terms had not been modified. An expense is recognized for any increase in the value of the transactions as a result of the modification, as measured at the date of modification.

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any expense not yet recognized for the award is recognized immediately. However, if a new award is substituted for the cancelled award, and designated as a replacement award on the date that it is granted, the cancelled and new awards are treated as if they were a modification of the original award, as described in the previous paragraph.

The dilutive effect of outstanding options is reflected as additional share dilution in the computation of earnings per share, see *Note 7 Earnings Per Common Share*.

Cash-settled transactions

Our Long-Term Incentive Plan, or LTIP, grants share appreciation rights, or SARs, to our eligible key executives and advisors. Under the LTIP, we recognize the services we receive from the eligible key executives and advisors, and our liability to pay for those services, as the eligible key executives and advisors render services during the vesting period. We measure our liability, initially and at each reporting date until settled, at the fair value of the SARs, by applying an option valuation model, taking into account the terms and conditions on which the SARs were granted, and the extent to which the eligible key executives and advisors have rendered service to date. We recognize any changes in fair value at each reporting date until settled, in profit and loss for the period.

Leases

Lease obligations having provisions for bargain purchase options, ownership transfer at the end of the lease term, or minimum lease payments, which approximate the fair market value of the property are capitalized. The related obligations are recognized as liabilities. Finance lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability.

A finance lease gives rise to a depreciation expense for the asset as well as a borrowing cost for each period. Finance charges are charged directly to current operations. The depreciation policy for leased assets is consistent with that for depreciable assets that are owned.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Initial direct costs incurred in negotiating an operating lease are added to the carrying amount of the leased assets and liabilities over the lease term on the same bases as the lease income. Operating lease payments are recognized as an expense in the consolidated statements of income on a straight-line basis over the lease term. For income tax reporting purposes, expenses that should have been incurred under lease agreement are considered as deductible expenses.

Revenue Recognition

Revenues for services are stated at amounts invoiced to customers and exclude value-added tax. We provide wireless communication services, fixed line communication services, and information and communications technology services. We provide such services to mobile, business, residential and payphone customers. Revenues, which exclude value-added tax, represent the value of fixed consideration that have been received or are receivable. Revenues are recognized when there is evidence of an arrangement, collectibility is reasonably assured and the delivery of the product or service has occurred.

Service revenues

Subscriptions

We provide telephone and data communication services under prepaid and postpaid payment arrangements. Revenues include fees for installation and activation are accrued upon subscription.

Air time, traffic and value-added services

Prepaid service revenues collected in advance are deferred and recognized based on the earlier of actual usage or upon expiration of the usage period. Interconnection revenues for call termination, call transit, and network usage are recognized in the period the traffic occurs. Revenues related to local, long distance, network-to-network, roaming and international call connection services are recognized when the call is placed or connection is provided, net of amounts payable to other telecommunication carriers for terminating calls in their territories. Revenues related to products and value-added services are recognized upon delivery of the product or service.

Directory services.

Revenue related to published directory services is recognized on a pro rata basis over the period in which the publication expires, which is generally 12 months. Telephone-based directory service revenue is recognized when the service is provided.

Incentives.

We record insignificant commission expense based on the number of new subscriber connections initiated by certain dealers. All other cash incentives provided to dealers and customers are recorded as a reduction from revenue. Product-based incentives provided to dealers and customers as part of a transaction are accounted for as multiple element arrangements and recognized when earned.

Non-service revenues

Handset and equipment sales

Sales of cellular handsets and communication equipment are recognized upon delivery to the customer.

Others

Interest income from cash deposits is recognized on a time proportion basis taking into account the principal amount outstanding and the effective interest rate.

Income Taxes

Deferred income tax is provided, using the balance sheet liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities and assets are recognized for all taxable temporary differences. Deferred income tax assets are recognized for all deductible temporary differences, carryforward of unused tax credits from excess minimum corporate income tax, or MCIT, and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carryforward of unused tax credits and unused tax losses can be utilized. Deferred income tax, however, is not recognized when it arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

Deferred tax liabilities are not provided on non-taxable temporary differences associated with investments in domestic subsidiaries and associates. With respect to investments in other subsidiaries and associates, deferred tax liabilities are recognized except when the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred income tax assets and liabilities are measured at the tax rate that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rate (and tax laws) that have been enacted or substantively enacted at balance sheet date.

Income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statements of income.

Earnings Per Common Share, or EPS

Basic EPS is calculated by dividing the net income for the period attributable to common shareholders (net income adjusted for dividends on all series of preferred shares except for dividends on preferred stock subject to mandatory redemption) by the weighted average number of common shares outstanding during the period, after giving retroactive effect to any stock dividend declarations.

Diluted EPS is calculated in the same manner assuming that, at the beginning of the period or at the time of issuance during the period, all outstanding options are exercised and convertible preferred shares are converted to common shares and appropriate adjustments to net income are effected for the related expenses on preferred shares. Outstanding stock options will have a dilutive effect under the treasury stock method only when the average market price of the underlying common share during the period exceeds the exercise price of the option.

Where the effect of the assumed conversion of the preferred shares and the exercise of all outstanding options have an anti-dilutive effect, basic and diluted EPS are stated at the same amount.

If the required dividends to be declared on each series of convertible preferred shares divided by the number of equivalent common shares, assuming such convertible preferred shares are converted to common shares, would decrease the basic EPS, then such convertible preferred shares would be deemed dilutive. As such, the diluted EPS will be calculated by dividing net income attributable to common shareholders (net income, adding back any dividends and/or other charges recognized in the period related to the dilutive convertible preferred shares classified as liability, less dividends on non-dilutive preferred shares except for dividends on preferred stock subject to mandatory redemption) by the weighted average common shares including the common share equivalent arising from the conversion of the dilutive convertible preferred shares.

3. Management s Use of Estimates

Our unaudited consolidated financial statements prepared in Philippine GAAP require management to make estimates and assumptions that affect amounts reported in our unaudited consolidated financial statements and related notes. In preparing our unaudited consolidated financial statements, we have made our best estimates and judgments of certain amounts, giving due consideration to materiality. We believe the following represent a summary of these significant estimates and judgments and related impact and associated risks in our unaudited consolidated financial statements.

Estimating useful lives of property, plant and equipment

We estimate the useful lives of our property, plant and equipment based on the period over which our assets are expected to be available for use. The estimated useful lives of our property, plant and equipment are reviewed periodically and are updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on the use of our assets. In addition, our estimation of the useful lives of our property, plant and equipment is based on our collective assessment of industry practice, internal technical evaluation and experience with similar assets. It is possible, however, that future results of operations could be materially affected by changes in our estimates brought about by changes in factors mentioned above. The amounts and timing of recorded expenses for any period would be affected by changes in these factors and circumstances. A reduction in the estimated useful lives of our property, plant and equipment would increase our recorded operating expenses and decrease our noncurrent assets. Property, plant and equipment amounted to Php190,176 million and Php194,525 million as at June 30, 2005 and December 31, 2004, respectively.

Asset impairment

Philippine GAAP requires that an impairment review be performed when certain impairment indicators are present. In case of goodwill and intangible assets with indefinite life, such assets are subject to yearly impairment test and whenever there is an indication that such asset may be impaired.

Purchase accounting requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair market values of the assets and liabilities purchased, including intangible assets and contingent liabilities. Our business acquisitions have resulted in goodwill. Instead, goodwill is subject to a periodic impairment test.

Determining the fair value of property, plant and equipment, investments and intangible assets, which requires the determination of future cash flows expected to be generated from the continued use and ultimate disposition of such assets, requires us to make estimates and assumptions that can materially affect our unaudited consolidated financial statements. Future events could cause us to conclude that property, plant and equipment, investments and intangible assets associated with an acquired business is impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

The preparation of the estimated future cash flows involves significant judgment and estimations. While we believe that our assumptions are appropriate and reasonable, significant changes in our assumptions may materially affect our assessment of recoverable values and may lead to future additional impairment charges under Philippine GAAP.

Total goodwill and intangible assets as at June 30, 2005 and December 31, 2004 amounted to Php3,727 million and Php3,864 million, respectively.

Investment properties

We have adopted the fair value approach in determining the carrying value of our investment properties. While we have opted to rely on independent appraisers to determine the fair value of our investment properties, such fair value was determined based on recent prices of similar properties, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices. The amounts and timing of recorded changes in fair value for any period would differ if we made different judgments and estimates or utilized different basis for determining fair value.

Total investment properties as at June 30, 2005 and December 31, 2004 amounted to Php732 million and Php743 million, respectively.

Deferred tax assets

We review the carrying amounts at each balance sheet date and reduce deferred tax assets to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax assets to be utilized. However, there is no assurance that we will generate sufficient taxable profit to allow all or part of our deferred tax assets to be utilized.

Unrecognized deferred tax assets as at June 30, 2005 and December 31, 2004 amounted to Php12,416 million and Php13,824 million, respectively.

Financial assets and liabilities

Philippine GAAP requires that we carry certain of our financial assets and liabilities at fair value, which requires extensive use of accounting estimates and judgment. In addition, certain liabilities acquired through debt exchange and restructuring are required to be carried at fair value at the time of the debt exchange and restructuring, see *Note 24 Financial Assets and Liabilities*. While significant components of fair value measurement were determined using verifiable objective evidence (i.e., foreign exchange rates, interest rates, volatility rates), the amount of changes in fair value would differ if we utilized different valuation methodology. Any changes in fair value of these financial assets and liabilities would affect directly our profit and loss and equity.

The fair value of financial assets and liabilities as at June 30, 2005 amounted to Php48,479 million and Php170,205 million, respectively.

The fair value of financial assets and liabilities as at December 31, 2004 amounted to Php46,439 million and Php194,613 million, respectively.

Estimating allowance for doubtful accounts

We estimate the allowance for doubtful accounts related to our trade receivables based on two methods. The amounts calculated using each of these methods are combined to determine the total amount we reserve. First, we evaluate specific accounts where we have information that certain customers are unable to meet their financial obligations. In these cases, we use judgment, based on the best available facts and circumstances, including but not limited to, the length of our relationship with the customer and the customer s current credit status based on third party credit reports and known market factors, to record specific reserves for customers against amounts due to reduce our receivables to amounts that we expect to collect. These specific reserves are re-evaluated and adjusted as additional information received affects the amounts estimated. Second, a general provision is established as a certain percentage of operating revenues based on the aging profile of receivables. This percentage is based on a collective assessment of historical collection, write-off experience, current economic trends, changes in our customer payment terms and other factors that may affect our ability to collect payments. Full allowance is provided for receivables from permanently disconnected subscribers and carriers. Such permanent disconnections generally occur within 105 days from due date. Partial allowance is provided for active subscribers and carriers based on the age status of receivables.

The amounts and timing of recorded expenses for any period would differ if we made different judgments or utilized different estimates. An increase in our allowance for doubtful accounts would increase our recorded operating expenses and decrease our current assets.

Provision for doubtful accounts amounted to Php1,526 million and Php1,875 million for the six months ended June 30, 2005 and 2004, respectively. Trade and other receivables, net of allowance for doubtful accounts, amounted to Php8,457 million and Php10,404 million as at June 30, 2005 and December 31, 2004, respectively.

Revenue recognition

Our revenue recognition policies require us to make use of estimates and assumptions that may affect the reported amounts of our revenues and receivables.

Our agreements with domestic and foreign carriers for inbound and outbound traffic subject to settlements require traffic reconciliations before actual settlement is done, which may not be the actual volume of traffic as measured by us. Initial recognition of revenues are based on our observed traffic adjusted by our normal experience adjustments, which historically are not material in our unaudited consolidated financial statements. Differences between the amounts initially recognized and actual settlements are taken up in the accounts upon reconciliation. However, there is no assurance that such use of estimates may not result to material adjustments in future periods.

Revenues under a multiple element arrangement specifically applicable to our wireless business were split into separately identifiable components and recognized when the related components were delivered in order to reflect the substance of the transaction. The fair value of components was determined using verifiable objective evidence. Revenue for handset sales has been quantified and identified separately using the residual value method from our cellular service revenue.

Pension and other retirement benefits

The determination of our obligation and cost for pension and other retirement benefits is dependent on our selection of certain assumptions used by actuaries in calculating such amounts. Those assumptions are described in *Note 21 Employee Benefits* and include among others, discount rates, expected returns on plan assets and rates of compensation increase. In accordance with Philippine GAAP, actual results that differ from our assumptions are accumulated and amortized over future periods and therefore, generally affect our recognized expense and recorded obligation in such future periods. While we believe that our assumptions are reasonable and appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our pension and other retirement obligations.

Unrecognized net actuarial gain as at June 30, 2005 and December 31, 2004 amounted to Php176 million.

Legal Contingencies

We are currently involved in various legal proceedings. Our estimate of the probable costs for the resolution of these claims has been developed in consultation with outside counsel handling our defense in these matters and is based upon an analysis of potential results. We currently do not believe these proceedings will have a material adverse effect on our consolidated financial statements. It is possible, however, that future results of operations could be materially affected by changes in our estimates or in the effectiveness of our strategies relating to these proceedings, see *Note 23 Provisions and Contingencies.*

Outstanding provisions to cover these contingencies amounted to Php4,767 million and Php4,548 million as at June 30, 2005 and December 31, 2004, respectively.

4. Segment Information

Operating segments are components of PLDT that engage in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of PLDT), whose operating results are regularly reviewed by the enterprise s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available. The accounting policies of the reportable segments are the same as those described in *Note 2 Summary of Significant Accounting Policies and Practices*.

We have organized our business into three main segments:

- Wireless wireless telecommunications services provided through our cellular service providers, Smart and Piltel, and satellite and very small aperture terminal, or VSAT, operators, namely PLDT s subsidiaries Mabuhay Satellite, ACeS Philippines and Telesat;

- Fixed Line fixed line telecommunications services primarily provided through PLDT. We also provide fixed line services through PLDT s subsidiaries Clark Telecom, Subic Telecom, Maratel, Piltel and BCC which together account for approximately 3% of our consolidated fixed lines in service, and PLDT Global; and

• Information and Communications Technology information and communications infrastructure and services for internet applications, internet protocol-based solutions and multimedia content delivery provided by PLDT s subsidiary ePLDT; call center services provided by ePLDT s subsidiaries Parlance Systems, Inc., or Parlance, Vocativ Systems, Inc., or Vocativ and Ventus; internet access and gaming services provided by ePLDT s subsidiaries Infocom Technologies, Inc., Digital Paradise and netGames; and e-commerce and IT-related services provided by other investees of ePLDT, as described in *Note 9 Investments in Associates*.

The segment assets and liabilities and results of operations of the segments in 2004 have been restated to reflect the effects of the change in accounting policies.

The segment assets as at June 30, 2005 and December 31, 2004 and results of operations of our reportable segments for the six months ended June 30, 2005 and 2004 reported under Philippine GAAP are as follows:

	Wireless	**Fixed Line**	**Information and Communications Technology** (in millions of pesos)	**Inter-segment Transactions**	**Total**
As at and for the six months ended June 30, 2005 (Unaudited)					
Revenues					
Service	36,703	24,214	1,328	(2,723)	59,522
Non-service	1,291		215	(84)	1,422
Others	57	122	44	(29)	194
Segment revenues	38,051	24,336	1,587	(2,836)	61,138
Result					
Income before income tax	17,592	4,850	69		22,511
Provision for income tax	4,217	1,471	6		5,694
Net income for the period	13,375	3,379	63		16,817
Assets					
Segment assets	91,611	198,300	4,199	(43,212)	250,898
Deferred income tax assets	557	11,729	5		12,291
Total assets	92,168	210,029	4,204	(43,212)	263,189
Other segment information					
Capital expenditures	3,577	3,129	306		7,012
Depreciation and amortization	4,970	5,704	187		10,861
Provisions	437	1,531			1,968

Interest on loans and related items - net of capitalized interest	898	4,541	14		5,453
Interest income	(543)	(193)	(5)		(741)

As at December 31, 2004 (Audited) and for the six months ended June 30, 2005 (Unaudited)

Revenues					
Service	33,983	24,108	953	(1,203)	57,841
Non-service	4,235		161	(85)	4,311
Others	135	107	13	(108)	147
Segment revenues	38,353	24,215	1,127	(1,396)	62,299
Result					
Income before income tax	15,298	908	53		16,259
Provision for income tax	3,529	284	(2)		3,811
Net income for the period	11,769	624	55		12,448
Assets					
Segment assets	94,623	198,090	3,716	(43,694)	252,735
Deferred income tax assets	8	12,721	9		12,738
Total assets	94,631	210,811	3,725	(43,694)	265,473
Other segment information					
Capital expenditures	8,827	2,673	75		11,575
Depreciation and amortization	5,779	5,000	148		10,927
Provisions	608	1,568			2,176
Interest on loans and related items - net of capitalized interest	852	5,324	25		6,201
Interest income	(367)	(98)	(3)		(468)

5. Revenues and Expenses

Non-service Revenues

	Six Months Ended June 30, **2005**	2004
	(Unaudited) (in million pesos)	
Sale of handsets and SIM-packs	**1,291**	4,235

Point of product sales	**131**	76
	1,422	4,311

Compensation and Benefits

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Salaries and benefits	**5,455**	5,177
Incentive plans (Note 21)	**610**	269
Pension and other benefits (Note 21)	**384**	367
Manpower rightsizing program	**43**	183
	6,492	5,996

Financing Costs

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Interest on loans and related items	**5,656**	6,503
Accretion on financial liabilities - net (Notes 2, 17 and 24)	**1,437**	1,496
Hedge costs (Note 24)	**557**	567
Dividends on preferred stock subject to mandatory redemption (Note 17)	**132**	117
Financing charges (Note 7)	**74**	86
Foreign exchange losses (gains) - net (Notes 17 and 24)	**(1,376)**	1,397
Loss (gain) on derivative transactions - net (Notes 2 and 24)	**(1,187)**	505
Interest income	**(741)**	(468)
Capitalized interest (Notes 2 and 8)	**(203)**	(302)
	4,349	9,901

Cost of Sales

	Six Months Ended June 30, 2005	2004
	(Unaudited) (in million pesos)	
Cost of handsets and SIM-packs sold	**3,149**	6,478
Cost of satellite air time (Notes 20 and 22)	**122**	121
	3,271	6,599

Provisions

	Six Months Ended June 30, 2005	2004
	(Unaudited) (in million pesos)	
Doubtful accounts (Note 14)	**1,526**	1,875
Write-down of inventories at net realizable value (Note 15)	**325**	128
Onerous contracts (Notes 20 and 22)	**117**	173
	1,968	2,176

Other Expenses

	Six Months Ended June 30, 2005	2004
	(Unaudited) (in million pesos)	
Operating expenses	**1,507**	1,411
Equity in net losses of associates		36
Others	**233**	101
	1,740	1,548

6. Income Taxes

The net components of deferred income tax recognized in the consolidated balance sheets are as follows:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Net assets	**12,291**	12,738
Net liabilities	**1,955**	1,943

The components of net deferred tax assets and liabilities are as follows:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Net assets		
Unrealized foreign exchange losses	**9,904**	11,214
Allowance for doubtful accounts	**5,417**	4,068
Unearned revenues	**2,883**	1,939
Unamortized past service cost	**1,036**	1,130
Pension and other benefits	**899**	761
Provisions for unrealized assets	**451**	453
Derivative instruments	**346**	595
Accumulated write-down of inventories at net realizable value	**330**	190
Interest charges capitalized	**(4,885)**	(4,558)
Foreign exchange differential capitalized	**(1,995)**	(1,520)
Preferred stock subject to mandatory redemption	**(814)**	(1,042)
Taxes and duties capitalized	**(550)**	(582)
Excess of fair value over cost of investment properties	**(106)**	(106)
Net loss operating carryover, or NOLCO		3
Others	**(625)**	193
	12,291	12,738
Net liabilities		
Unearned revenues	**545**	673
NOLCO	**257**	1,063
Provisions for unrealizable assets	**125**	13
Accumulated write-down of inventories at net realizable value	**31**	203
Gain on debt exchange and restructuring	**(1,802)**	(2,958)

Intangibles and fair value adjustment on assets acquired	**(1,157)**	(1,231)
Derivative instruments	**(46)**	20
Allowance for doubtful accounts		798
Foreign exchange differential capitalized		(644)
Interest charges capitalized		(485)
Unrealized foreign exchange losses		432
Others	**92**	173
	(1,955)	(1,943)

Provision for income tax consists of:

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Current	**5,003**	4,230
Deferred	**691**	(419)
	5,694	3,811

The reconciliation between the provision for income tax at the applicable statutory tax rates and the actual provision for income tax follows:

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Provision for income tax at statutory tax rate	**7,203**	5,203
Tax effects of:		
Non-deductible expenses	**245**	557
Income subject to lower tax rate	**113**	(66)
Equity share in net losses of investees including provision for decline in value of investments in associates	**1**	10
Net reversal of deferred income tax assets	**(1,638)**	(172)
Income subject to final tax	**(228)**	(246)
Income not subject to tax	**(2)**	(1,475)
Actual provision for income tax	**5,694**	3,811

Mabuhay Satellite and Subic Telecom are registered as Subic Bay Freeport Enterprises while Clark Telecom is registered as a Clark Special Economic Zone Enterprise under R.A. No. 7227, otherwise known as the Bases Conversion and Development Act of 1992, or the Act. As registrants, Mabuhay Satellite, Subic Telecom and Clark Telecom are entitled to all the rights, privileges and benefits established thereunder including tax and duty-free importation of capital equipment and special income tax rate of 5% of gross income, as defined in the Act.

On December 22, 2000, the Philippine Board of Investments, or BOI, approved ePLDT s registration as a new information technology, or IT, service firm in the field of services related to its internet data center on a pioneer status. As such, ePLDT enjoys, among other incentives, a six-year income tax holiday, or ITH, from January 2001.

Parlance is registered with the BOI as a new IT export service firm in the field of customer interaction center on a pioneer status. Under this registration, Parlance shall be entitled to certain tax incentives like ITH for six years starting June 2002. Parlance is required to comply with specific terms and conditions stated in the BOI registration.

iPlus Intelligent Network, Inc., or iPlus, is registered with the BOI as a new IT service firm in the field of application service provider on a pioneer status. Under such registration, iPlus is entitled to a six-year ITH incentive from the actual start of commercial operations until January 1, 2009. Income derived from non-registered activities is subject to a normal income tax rate of 32%.

Vocativ is registered with the PEZA as an Ecozone Export Enterprise to develop and operate a call center business that serves overseas clients by providing customer relationship management services. As a registered enterprise, Vocativ is entitled to certain tax and nontax incentives which include, among others, tax and duty-free importations, exemption from local taxes and ITH for four years from start of commercial operations. After the ITH period, Vocativ is liable for a final tax, in lieu of all taxes after the expiration of its incentives. The final tax is computed at 5% of gross income less allowable deductions as defined under R.A. No. 7916, The Special Economic Zone Act of 1995, and shall be paid and remitted in accordance with the amendments contained in R.A. No. 8748, as follows: (a) 3% to the National Government; and (b) 2% which shall be directly remitted by the business establishments to the treasurer s office of the municipality or city where the enterprise is located.

mySecureSign, Inc., or mSSI, is registered with the BOI as a new IT service firm in the field of services related to public key infrastructure on a pioneer status. Under such registration, mSSI enjoys, among other incentives, a six-year ITH from August 1, 2001 or actual start of commercial operations, whichever comes first. mSSI started commercial operations on January 1, 2002.

Ventus is registered with the BOI as a new IT export service firm in the field of customer interaction center on a pioneer status. Under this registration, Ventus shall be entitled to certain tax incentives such as ITH for six years starting March 2005. In relation to this, Ventus is required to comply with specific terms and conditions stated in the

BOI registration.

On May 3, 2001, the BOI awarded Smart pioneer status for its GSM expansion projects entitling it to a three-year ITH which expired on May 2, 2004. The tax incentive was utilized by Smart on the basis of incremental income generated from such expansion projects. In addition, on July 12, 2001, the BOI awarded Smart pioneer status for its payment infrastructure projects, entitling it to enjoy a six-year ITH. In this case, the tax incentive is availed for the entire taxable income of the project. The BOI registration for this project was cancelled effective September 14, 2004, which resulted in the termination of all incentives granted to Smart by virtue of its registration.

Wolfpac Communications, Inc., or Wolfpac, is registered with the BOI as a new operator of service provider applications. Under the terms of its registration, it is entitled to certain tax and non-tax incentives which include, among others, an ITH for four years from February 2004.

Meridian is registered with the BOI as a new operator of telecommunications systems (inter-exchange carrier for data services). Under the terms of its registration, Meridian is entitled to certain tax and non-tax incentives which include, among others, an ITH for six years from February 2001 or the actual start of commercial operations, whichever comes first, and additional deduction for labor expense for the first five years from the date of registration.

Consolidated tax incentives availed for the six months ended June 30, 2005 and 2004 amounted to Php43 million and Php1,554 million, respectively.

Smart s deferred income tax assets and liabilities as at June 30, 2005 and December 31, 2004 have been recorded to the extent that such deferred tax assets are expected to be utilized against sufficient future taxable profit.

Certain deferred income tax assets have not been recognized as it is not probable that taxable profits will be sufficient against which they can be utilized. The components of deductible temporary differences for which no deferred tax asset is recognized in the consolidated balance sheets are as follows:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Asset impairment	**9,493**	10,090
Unrealized foreign exchange losses	**1,711**	1,938
Allowance for doubtful accounts	**755**	746
MCIT	**383**	305
NOLCO	**27**	29
Unearned revenues on co-location fees		470

Provision for other assets		133
Unearned revenues on sale of prepaid cards		73
Others	**47**	40
	12,416	13,824

Our consolidated unutilized NOLCO as at June 30, 2005 is detailed as follows:

Year Incurred	**Year Expiring**	**(in million pesos)**
2002	2005	775
2003	2006	5
2004	2007	72
		852
Tax benefit		284
Unrecognized deferred income tax assets as at June 30, 2005		(27)
		257

7. Earnings Per Common Share

The following table presents information necessary to calculate the earnings per common share:

	Six Months Ended June 30,			
	2005		2004	
	Basic	**Diluted**	Basic	Diluted
	(Unaudited) (in million pesos)			
Net income	**16,785**	**16,785**	12,423	12,423
Dividends on preferred shares	**(756)**	**(24)**	(765)	(25)
Dividend on preferred stock subject to mandatory redemption charged to interest expense for the period		**44**		41
Accretion of preferred stock subject to mandatory redemption		**152**		223
Foreign exchange gain on preferred stock subject to mandatory redemption		**(474)**		(32)
Net income applicable to common shares	**16,029**	**16,483**	11,658	12,630
	(in thousands, except per share amounts)			

Outstanding common shares, beginning	**170,214**	**170,214**	169,476	169,476
Effect of issuance of common shares during the period	**318**	**318**	28	28
Weighted average number of shares under ESOP during the period		**66**		49
Common shares equivalent of preferred shares deemed dilutive:				
Preferred Stock Series A to FF (Note 16)		**3,218**		4,432
Global Depositary Stock Series III (Note 16)		**7,908**		7,907
Preferred Stock Series VII (Note 17)		**3,842**		3,842
Weighted average number of common shares, end	**170,532**	**185,566**	169,504	185,734
Earnings per common share	**Php94.00**	**Php88.83**	Php68.78	Php68.00

Dividends Declared For the Six Months Ended June 30, 2005

Class	Date Approved	Record	Payable	Amount Per Share	Total (in million pesos)
Preferred Stock Subject to Mandatory Redemption					
Series V	March 1, 2005	March 17, 2005	April 15, 2005	Php4.675	10
	June 14, 2005	June 28, 2005	July 15, 2005	4.675	7
Series VI	March 1, 2005	March 17, 2005	April 15, 2005	US$0.09925	26
	June 14, 2005	June 28, 2005	July 15, 2005	0.09925	20
Series VII	March 1, 2005	March 17, 2005	April 15, 2005	JPY10.179725	20
	June 14, 2005	June 28, 2005	July 15, 2005	10.179725	26
Charged to income					109
10% Cumulative Convertible Preferred Stocks					
Series DD	January 25, 2005	February 8, 2005	February 28, 2005	Php1.00	3
Series CC	January 25, 2005	February 24, 2005	March 31, 2005	1.00	17
Series A, I, R, W, AA & BB	June 28, 2005	July 28,2005	August 31,2005	1.00	129
					149
Convertible Preferred Stocks					
Series III	March 1, 2005	March 17, 2005	April 15, 2005	US$1.029412	260
	June 14, 2005	June 28, 2005	July 15, 2005	1.029412	267
					527
Cumulative Non-Convertible Redeemable Preferred Stock					

Series IV*	January 25, 2005	February 17, 2005	March 15, 2005		12
	May 3, 2005	May 26, 2005	June 15, 2005		12
					24
Common stock	March 1, 2005	March 31, 2005	May 12, 2005	Php14.00	2,384
	May 5, 2005	June 3, 2005	July 14, 2005	21.00	3,598
					5,982
Charged to retained earnings					6,682

** Dividends are declared based on total amounts, not per share amounts.*

Retained earnings available for cash dividends amounted to Php23,564 million as at June 30, 2005. Reconciliation of consolidated deficit to Parent Company retained earnings is shown below:

	(in million pesos)
Deficit in the unaudited consolidated financial statements	(117)
Adjustments relating to:	
PAS 27 Consolidated and Separate Financial Statements	23,567
PAS 36 Impairment of Assets	(2,025)
PAS 40 Investment Property	2,139
Retained earnings in the separate financial statements of the Parent Company	23,564

8. Property, Plant and Equipment

This account consists of:

Cable and wire facilities	**Central office equipment**	**Cellular facilities**	**Buildings**	**Vehicles, furniture, and other work equipment**	**Communications satellite**	**Information origination/ termination equipment**	**Land and land improvements**	**Property under construction**	**T**
					(in million pesos)				

cember 31, 2004 (Audited)										
	102,958	76,117	64,092	19,083	28,474	15,709	6,108	2,563	9,972	32
nulated ciation, zation and rment	(30,091)	(36,126)	(31,080)	(4,911)	(16,859)	(8,907)	(2,151)	(341)	(85)	(13
ook value	72,867	39,991	33,012	14,172	11,615	6,802	3,957	2,222	9,887	19
onths Ended June 30, 2005 (Unaudited)										
ook value - ning	72,867	39,991	33,012	14,172	11,615	6,802	3,957	2,222	9,887	19
ons/Transfers -	1,339	601	1,756	149	773	573	425	15	1,417	
sals/Retirement	(69)	(4)	(149)	(16)	(84)	(54)	(11)	(7)	(144)	
ciation and zation	(1,991)	(2,206)	(2,860)	(1,214)	(1,723)	(437)	(347)	(81)		(1
ook value - end	72,146	38,382	31,759	13,091	10,581	6,884	4,024	2,149	11,160	19
ne 30, 2005 (Unaudited)										
	104,214	76,711	65,486	19,211	29,069	16,227	6,443	2,571	11,244	33
nulated ciation, zation and rment	(32,068)	(38,329)	(33,727)	(6,120)	(18,488)	(9,343)	(2,419)	(422)	(84)	(14
ook value	72,146	38,382	31,759	13,091	10,581	6,884	4,024	2,149	11,160	19

Substantially all our telecommunications equipment are purchased from outside the Philippines. Significant source of financing for such purchases are foreign loans requiring repayment in currencies other than Philippine pesos, principally in U.S. dollars (see *Note 17 Interest-bearing Financial Liabilities*). Interest, using an average capitalization rate of 8%, and net foreign exchange losses capitalized to property, plant and equipment qualified as borrowing costs for the six months ended June 30, 2005 and 2004 were as follows:

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Interest	**203**	302
Foreign exchange losses (gains)	**(156)**	55

As at June 30, 2005 and December 31, 2004, the undepreciated capitalized net foreign exchange losses qualified as borrowing costs amounted to Php5,047 million and Php5,528 million, respectively.

For the six months ended June 30, 2005, we recognized additional depreciation of Php578 million with our full adoption of PAS 16, see *Note 2 Summary of Significant Accounting Policies*.

In 2004, certain assets with net book values aggregating Php365 million were retired. These assets relate primarily to certain international facility equipment of PLDT Global and Subic Telecom in relation to our strategic direction to functionally integrate our international fixed line business.

Certain property, plant and equipment have been restated to include the following amounts for capitalized leases as at June 30, 2005 and December 31, 2004:

	June 30, 2005 (Unaudited)			December 31, 2004 (Audited)		
	Central office equipment	**Vehicles, furniture and other network equipment**	**Total**	Central office equipment	Vehicles, furniture and other network equipment	Total
	(in million pesos)					
Cost	**361**	**1,030**	**1,391**	361	863	1,224
Less accumulated depreciation	**282**	**577**	**859**	269	410	679
	79	**453**	**532**	92	453	545

The following table describes all changes to the asset retirement obligations as at June 30, 2005 and December 31, 2004, respectively:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Asset retirement obligations at beginning of period	**638**	395
Additional liability recognized during the period	**37**	177
Settlement of obligations	**(4)**	
Accretion expense	**38**	66
Asset retirement obligations at end of period (note 18)	**709**	638

9. Investments in Associates

This account consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
ACeS International Limited, or AIL	**1,614**	1,614
Mabuhay Space Holdings Limited	**1,046**	1,077
Stradcom International Holdings, Inc.	**616**	616
Bayantrade Dotcom, Inc.	**97**	97
ePDS, Inc.	**6**	6
Airborne Access Corporation	**2**	2
	3,381	3,412
Less accumulated impairment and equity in net losses of associates	**3,369**	3,404
Total cost and accumulated impairment and equity in net losses of associates	**12**	8

Investment of ACeS Philippines in AIL

As at June 30, 2005, ACeS Philippines has a 20% investment in AIL, a company incorporated under the laws of Bermuda. AIL owns the Garuda I Satellite and the related system control equipment in Batam, Indonesia.

In December 1998, AIL and its 95% owned subsidiary, PT Asia Cellular Satellite, entered into an Amended and Restated Credit Agreement, or Amended Agreement, to amend the original Credit Agreement entered into by PT Asia Cellular Satellite and its bank creditors in 1997. Under the Amended Agreement, AIL has, among others, assigned to the banks as collateral all of its tangible properties, including the Garuda I Satellite, the system control facilities and system control equipment. On September 30, 2002, PT Asia Cellular Satellite, AIL, as guarantor, P.T. Bank Internasional Indonesia, as security agent, and various banks signed the Rescheduling Agreement, which amended the terms of the Amended and Restated Credit Agreement dated December 29, 1998, moving the principal repayment dates to agreed periods with the final maturity date on January 31, 2012, see *Note 20 Related Party Transactions*.

AIL has incurred recurring significant operating losses, negative operating cash flows, and significant levels of debt. The financial condition of AIL was partly due to the National Service Providers , or NSPs, inability to generate the amount of revenues originally expected as the growth in subscriber numbers have been significantly lower than budgeted. These factors raise substantial doubt about AIL s ability to continue as a going concern. On this basis, we recognized an impairment provision in respect of our investment in AIL amounting to Php1,614 million in 2003.

Investment of Mabuhay Satellite in Mabuhay Satellite Space Holdings Limited, or MSHL

In 1996, Mabuhay Satellite entered into a Joint Venture Agreement, or JVA, with Space Systems/Loral Inc., or SS/L, to form MSHL for the purpose of providing high-power Ku-Band satellite transmission services using the payload which was added by SS/L aboard Agila II. Under the terms of the JVA, SS/L is required to convey title to the additional payload service to MSHL in consideration for SS/L s 35% equity interest in MSHL and Mabuhay Satellite is required to pay SS/L US$19 million for a 65% equity interest in MSHL.

In 2000, SS/L filed a Notice of Default and Termination against Mabuhay Satellite arising from the latter s alleged failure to amicably resolve its unpaid obligation to SS/L under the JVA. In 2002, the arbitration panel handed down its decision and provided for payment by Mabuhay Satellite to SS/L of the principal amount of US$10 million plus accrued interest at 9% per annum. On June 30, 2003, Mabuhay Satellite and SS/L concluded a US$15 million settlement agreement under which Mabuhay Satellite leased two transponders under a transponder agreement on a life-term basis to SS/L and had offset the lease charges due from SS/L and its receivables from Loral Skynet Network Services, Inc. (formerly known as the Loral Cyberstar, Inc.), among others, for a full and final settlement of the arbitration decision. The agreement was subsequently approved by Mabuhay Satellite s creditors in March 2004.

In accordance with the settlement agreement, Mabuhay Satellite and SS/L shall proceed to dissolve the joint venture under a separate agreement, for which each of the parties shall receive title over such number of transponders owned by the joint venture in proportion to their respective interests. On the basis of the joint venture dissolution, we recognized an impairment provision in respect of our investment in MSHL of Php423 million in 2004.

Investment in Stradcom International Holdings, Inc., or SIHI

ePLDT has 22.5% interest in convertible securities of SIHI, the parent company of Stradcom Corporation, which has an existing concession agreement with the Philippine Government for the modernization of the Philippine Land Transportation Office, including the computerization of driver s license issuance, vehicle registration and traffic adjudication systems. SIHI has been incurring losses from the start of operations due to Stradcom Corporation s continuous losses and consistent excess of current liabilities over current assets. On this basis, we recognized an impairment provision in respect of our investment in SIHI of Php616 million in 2004.

Investment in BayanTrade Dotcom, Inc., or BayanTrade

BayanTrade was incorporated and registered with the SEC on August 8, 2000 to provide: (a) business-to-business electronic purchasing marketplace to link buyers and suppliers of good services over the Internet; (b) electronic catalogue purchasing facilities over the Internet to buyers and suppliers; (c) link-up with similar horizontal markets and vertical markets across the Asia-Pacific Region and the world; and (d) such facilitating services incidental to the business. BayanTrade is an e-procurement joint venture established together with six of the Philippines leading conglomerates. ePLDT s initial shareholding in BayanTrade was originally 20.5%, which was subsequently diluted to 19.17% in August 2004 due to an equity call to which ePLDT did not subscribe.

Investment in ePDS, Inc., or ePDs

On June 30, 2003, ePLDT signed a Joint Venture Agreement with DataPost Pte Ltd., or DataPost, a subsidiary of Singapore Post, and G3 Worldwide ASPAC, or Spring, pursuant to which the parties formed ePDS, a bills printing company which will do laser printing and enveloping services for statements, bills and invoices, and other value-added services to companies in the Philippines. ePLDT has a 50% interest in ePDS, while DataPost has a 30% interest. Spring, the largest international mail services provider, owns the remaining 20%. ePDS has an initial paid-up capital of Php11 million.

Investment in Airborne Access Corporation, or Airborne Access

On August 31, 2003, ePLDT signed a Memorandum of Agreement with Airborne Access to acquire a 20% interest at a purchase price of Php2 million. Airborne Access, a pioneering wireless internet service provider, caters primarily to mobile professionals by delivering wireless internet access to its subsidiaries through more than 44 hotspots throughout Metro Manila. In December 2004, ePLDT has recognized full provision in respect of its investment in Airborne Access due to its continuous losses which exceeded its paid-up capital.

10. Investment Properties

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Balance at beginning of period	**743**	761
Additions (subsequent expenditures)		3
Disposal	**(11)**	
Net loss from fair value adjustment		(21)
Balance at end of period	**732**	743

Investment properties are stated at fair values, which have been determined based on latest valuations performed by an independent firm of appraisers. The valuation undertaken was based on an open market value, supported by market evidence in which assets could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm s-length transaction at the date of valuation, in accordance with international valuation standards.

11. Goodwill and Intangible Assets

This account includes intangible assets technology application arising from the acquisition of Wolfpac and intangible assets franchise arising from acquisition of Meridian.

Movements in the goodwill and intangible assets during the periods are as follows:

	June 30, 2005 (Unaudited)			December 31, 2004 (Audited)		
	Goodwill	**Intangible assets**	**Total**	Goodwill	Intangible assets	Total
	(in million pesos)					
Cost:						
Balance at beginning of period	**528**	**3,955**	**4,483**	498	317	815
Additions		**15**	**15**	30	3,638	3,668
Balance at end of period	**528**	**3,970**	**4,498**	528	3,955	4,483
Accumulated amortization and impairment:						
Balance at beginning of period	**(438)**	**(181)**	**(619)**	(438)	(5)	(443)
Additions		**(152)**	**(152)**		(176)	(176)
Balance at end of period	**(438)**	**(333)**	**(771)**	(438)	(181)	(619)
Net balance	**90**	**3,637**	**3,727**	90	3,774	3,864

12. Notes Receivable

Investment of ePLDT in Debt Securities of Technology Support Services, Inc., or TSSI (formerly First Advance Multi-Media Entertainment Corp., or FAME)

On June 1, 2004, ePLDT and TSSI entered an agreement whereby ePLDT would grant a seven-year non-interest bearing loan to TSSI amounting to US$3.1 million. At the option of ePLDT, the loan is convertible into 20% of the total outstanding capital stock of TSSI at any time during the life of the outstanding loan.

On August 20, 2004, FAME changed its corporate name into TSSI.

On September 14, 2004, ePLDT entered into a second agreement with TSSI whereby ePLDT would grant another seven-year non-interest bearing loan to TSSI amounting to US$3.1 million. At the option of ePLDT, the loan is convertible into another 20% of the outstanding capital stock of TSSI at any time during the life of the outstanding loan. As at December 31, 2004, aggregate loans of ePLDT to TSSI amounted to US$5.1 million. The remaining balance of the loans of US$1.1 million was released to TSSI in February 2005.

ePLDT has not yet converted its investment in debt securities to TSSI s shares of stock as at June 30, 2005. TSSI is a systems integrator for the internet and mobile telephone gaming project.

The fair value of the debt instrument was computed as the present value of estimated future cash flows. The cost of the instrument approximates the fair value computed as at June 30, 2005.

13. Cash and Cash Equivalents

This account consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Cash on hand and in banks	**2,241**	4,750
Temporary investments	**33,388**	22,571
	35,629	27,321

Cash in banks earns interest at prevailing bank deposit rates. Temporary investments are made for varying periods of up to two months depending on our immediate cash requirements, and earn interest at the prevailing short-term deposit rates. Due to the short-term nature of such transactions, the carrying value approximates the fair value of our temporary investments.

14. Trade and Other Receivables

This account consists of receivables from:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Customers and carriers	**26,729**	27,280
Others (Notes 20, 22 and 23)	**1,290**	1,192
	28,019	28,472
Less allowance for doubtful accounts	**19,562**	18,068
	8,457	10,404

Receivables from carriers represent receivables arising from interconnection agreements with other telecommunications carriers. The aforementioned receivable balances are shown net of related payables to the same telecommunications carriers because an established right of offset exists.

On October 10, 2002, PLDT entered into a Receivables Purchase Deed, or RPD, with a foreign financial institution, or the Purchaser, under which PLDT agreed (1) to sell its receivables from certain eligible foreign carriers for an advance payment of US$50 million, of which, US$23 million remains outstanding as at June 30, 2005, and (2) to service, administer and collect the receivables on behalf of the Purchaser. Under the RPD, the Purchaser has no recourse against PLDT should an eligible carrier fail or refuse to settle the assigned/purchased receivables, except when PLDT commits a breach of its representations and warranties under the RPD.

Sale of receivables under the RPD amounted to US$6 million (Php338 million) and US$5 million (Php297 million) for the six months ended June 30, 2005 and 2004, respectively. Loss on sale of receivables under the RPD amounted to US$0.67 million (Php38 million) and US$0.65 million (Php37 million) for the six months ended June 30, 2005 and 2004, respectively.

15. Inventories and Supplies

This account consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Terminal and cellular phone units:		
At net realizable value	**665**	1,357
At cost	**1,183**	1,895
Spare parts and supplies:		
At net realizable value	**443**	389
At cost	**1,034**	985
Others (At cost)	**1,147**	394
	2,255	2,140

16. Equity

The movement of PLDT s capital account follows:

	Preferred Stock Php10 par value					Common Stock Php5 par value	
	Series A to FF	III	IV				
	No. of Shares			Total Preferred Stock	Amount	No. of Shares	Amount
	(in million shares and pesos)						
Authorized				823	Php8,230	234	Php1,170
Outstanding							
Balance at January 1, 2004	410	5	36	451	Php4,505	169	Php847
Issuance	1			1	9		2
Conversion	(2)			(2)	(17)	1	2

Balance at December 31, 2004 (Audited)	409	5	36	450	Php4,497	170	Php851
Balance at January 1, 2005	409	5	36	450	Php4,497	170	Php851
Issuance					1		1
Conversion	(1)			(1)	(11)	1	5
Balance at June 30, 20 05 (Unaudited)	408	5	36	449	Php4,487	171	Php857

Preferred Stock

The preferred stock is non-voting, except as specifically provided by law, and is preferred as to liquidation.

The Series A to FF 10% Cumulative Convertible Preferred Stocks earn cumulative dividends at an annual rate of 10%. After the lapse of one (1) year from the last day of the year of issuance of a particular series of 10% Cumulative Convertible Preferred Stock, any holder of such series may convert all or any of the shares of 10% Cumulative Convertible Preferred Stock held by him into fully paid and non-assessable shares of Common Stock of PLDT, at a conversion price equivalent to 10% below the average of the high and low daily sales price of a share of Common Stock on the PSE, or if there shall have been no such sales on the PSE on any day, the average of the bid and the asked prices of a share of Common Stock of PLDT at the end of such day on such Exchange, in each such case averaged over a period of 30 consecutive trading days prior to the conversion date, but in no case shall the conversion price be less than the price set by the Board of Directors which, as at December 31, 2004, was Php5.00 per share. The number of shares of Common Stock issuable at any time upon conversion of one share of subscriber investment plan, or SIP. Cumulative Convertible Preferred Stock shall be determined by dividing Php10.00 by the then applicable conversion price.

In case the shares of Common Stock at anytime outstanding shall be subdivided into a greater or consolidated into a lesser number of shares, then the minimum conversion price per share of Common Stock shall be proportionately decreased or increased, as the case may be, and in the case of a stock dividend, such price shall be proportionately decreased, provided, however, that in every case the minimum conversion price shall not be less than the par value per share of Common Stock. In the event the relevant effective date for any such subdivision or consolidation of shares or stock dividend occurs during the period of 30 trading days preceding the presentation of any shares of 10% Cumulative Convertible Preferred Stock for conversion, a similar adjustment shall be made in the sales prices applicable to the trading days prior to such effective date utilized in calculating the conversion price of the shares presented for conversion.

In case of any other reclassification or change of outstanding shares of Common Stock, or in case of any consolidation or merger of PLDT with or into another corporation, the Board of Directors shall make such provisions, if any, for adjustment of the minimum conversion price and the sales price utilized in calculating the conversion price as the Board of Directors, in it sole discretion, shall deem appropriate.

At PLDT s option, the Series A to FF 10% Cumulative Convertible Preferred Stock are redeemable at par value plus accrued dividends five years after the year of issuance.

On January 27, 2004, the Board of Directors designated 1 million shares of serial preferred stock as Series EE 10% Cumulative Convertible Preferred Stock for issuance throughout 2004, wich is an exempt transaction under Section 10.2 of the SRC as confirmed by SEC on March 22, 2004.

On December 9, 2004, the Board of Directors designated 500,000 shares of serial preferred stock as Series FF 10% Cumulative Convertible Preferred Stock for issuance throughout 2005 wherein exemption of these transactions under Section 10.2 of the SRC is still awaiting confirmation from SEC.

The Series III Convertible Preferred Stock earns cumulative dividends at an annual rate of US$3.50 a share payable quarterly, free and clear of Philippine withholding taxes. It is convertible into Common Stock at the option of the holder at any time, at the conversion price of US$29.19 per share of Common Stock (equivalent to a conversion ratio of 1.7129 shares of Common Stock for each share of Series III Convertible Preferred Stock, each share of Series III Convertible Preferred Stock being valued for this purpose at its reference amount of US$50 a share), subject to adjustment in certain events; and are not redeemable. Moreover, PLDT may require the mandatory conversion of some or all of the outstanding shares of Series III Convertible Preferred Stock into shares of common stock at the above conversion price of US$29.19 per share of common stock, if certain conditions are met, including that (i) the average of the closing prices of the ADSs reported on the NYSE on each trading day during the period of 30 days ending on the seventh day prior to the date upon which notice of the date of mandatory conversion is first given is greater than or equal to the conversion price in effect on such seventh day, (ii) there are no dividends in arrears on any shares of the Series III Convertible Preferred Stock, and (iii) PLDT has sufficient distributable reserves to pay the fixed preferential dividends on the shares of Series III Convertible Preferred Stock, calculated down to and including the mandatory conversion date. Upon liquidation of PLDT, holders of the Series III Convertible Preferred Stock will be entitled to receive liquidating distributions equivalent to Php11 per share, plus accrued and unpaid dividends to the date of distribution, subject to the prior rights of creditors.

The Series IV Cumulative Non-Convertible Redeemable Preferred Stock earns cumulative dividends at an annual rate of 13.5% based on the paid-up subscription price. It is redeemable at the option of PLDT at any time one year after subscription and at the actual amount paid for such stock, plus accrued dividends. On February 26, 2002, the Board of Directors called for the payment of a portion of the balance of the subscription price of the Series IV Cumulative Non-Convertible Redeemable Preferred Stock amounting to Php72 million, which was paid on March 5, 2002. On March 22, 2002, PLDT redeemed 60 million shares out of the 360 million subscribed shares of its Series IV Cumulative Non-Convertible Preferred Stock and paid Php72 million, representing the redemption price plus unpaid dividends up to the date of redemption.

The provisions of certain subscription agreements involving preferred stock have an effect on the ability of PLDT to, without written consent, sell certain assets and pay cash dividends unless all dividends for all past quarterly dividend periods have been paid and provision has been made for the currently payable dividends.

17. Interest-bearing Financial Liabilities

This account consists of the following:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Long-term portion of interest-bearing financial liabilities - net of current portion:		
Long-term debt	**102,675**	121,012
Obligations under capital lease (Note 8)	**516**	601
Preferred stock subject to mandatory redemption	**13,611**	14,375
	116,802	135,988
Current portion of interest-bearing financial liabilities:		
Long-term debt maturing within one year	**28,880**	28,018
Obligations under capital lease maturing within one year (Note 8)	**527**	425
Notes payable	**56**	58
	29,463	28,501

Unamortized debt discount, representing debt issuance costs and any difference between the fair value of consideration given or received on initial recognition, included in following financial liabilities are as follows:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Long-term debt	**9,913**	10,440
Obligations under capital lease (Note 8)	**699**	741
Preferred stock subject to mandatory redemption	**4,758**	6,182
Total unamortized debt discount	**15,370**	17,363

The following table describes all changes to unamortized debt discount as at June 30, 2005 and December 31, 2004.

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Unamortized debt discount at beginning of period	**17,363**	16,390
Additions during the period	**157**	7,765
Accretion during the period charged to financing costs (Note 5)	**(1,430)**	(3,452)
Revaluations	**473**	474
Settlement and conversions during the period	**(1,193)**	(3,814)
Unamortized debt discount at end of period	**15,370**	17,363

Long-term Debt

Long-term debt consists of:

Description	Interest Rates	June 30, 2005 (Unaudited)		December 31, 2004 (Audited)	
		(in millions)			
U.S. Dollar Debt:					
Export Credit Agencies-Supported Loans:					
Kreditanstalt für Wiederaufbau, or KfW	5.65% - 8.03% and US$ LIBOR + 0.55% - 2.5%	**US$306**	**Php17,201**	US$351	Php19,793
Finnish Export Credit or Finnvera	6.36% - 7.75% and US$ LIBOR + 0.5% - 1.425%	**136**	**7,657**	159	8,964
Nippon Export and Investment Insurance of Japan, or NEXI	US$ LIBOR +1%	**61**	**3,445**	74	4,179
Japan Bank for International Cooperation, or JBIC/Co-financing Banks	6.56% - 7.95% and US$ LIBOR + 0.65% - 1.55%	**29**	**1,627**	44	2,459
Others	5.83% - 7.89% and US$ LIBOR + 0.15% - 4.30% and GOVCO s cost + 0.20%	**51**	**2,872**	104	5,871
		583	**32,802**	732	41,266
Fixed Rate Notes	7.85% - 11.375%	**1,176**	**66,043**	1,220	68,795
Term Loans:					
Debt Exchange Facility	2.25% and US$ LIBOR + 1%	**160**	**8,976**	155	8,721
GSM Network Expansion Facilities	4.49% and US$ LIBOR + 1%-3.25%	**110**	**6,195**	125	7,046
Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO	US$ LIBOR + 1.95% - 2.05%			51	2,862
Others		**23**	**1,295**	33	1,863

	5.83% and LIBOR + 0.40% - 3.625%				
Restructured Loans	US$ LIBOR + 1%	**88**	**4,917**	85	4,815
Satellite Acquisition Loans	US$ LIBOR + 1.75% and 5.6%	**65**	**3,635**	72	4,064
		US$2,205	**123,863**	US$2,473	139,432
Japanese Yen Debt:					
JBIC s Overseas Investment Loan, or OIL	2.125%	**JP¥8,364**	**4,238**	JP¥9,760	5,363
Export Credit Agency-Supported Loan	JP¥ LIBOR + 1.70%	**1,887**	**956**	2,205	1,212
NEXI Supported Loan					
		JP¥10,251	**5,194**	JP¥11,965	6,575
Philippine Peso Debt:					
Peso Fixed Rate Corporate Notes	14% - 15.816%		**1,575**		1,675
Term Loans:					
JBIC 4 Program	11.18%		**340**		680
Secured Term Loans	11% - 24%		**212**		305
Restructured Loans	91-day T-Bill + 1%		**371**		363
			2,498		3,023
			131,555		149,030
Less portion maturing within one year			**281,880**		28,018
Total long-term debt			**Php102,675**		Php121,012

Note: Amounts presented are net of unamortized debt discount and debt issuance costs.

The scheduled maturities of our outstanding unaudited consolidated long-term debt at nominal values as at June 30, 2005 are as follows:

	U.S. Dollar Loans		**JPY Loans**		**Php Loans**	**Total**
	In U.S. Dollar	**In Php**	**In JPY**	**In Php**	**In Php**	**In Php**
	(in millions)					
Year						
2005(1)	238	13,389	1,709	866	368	14,623
2006	337	18,947	3,418	1,732	847	21,526
2007	443	24,882	3,418	1,732	73	26,687
2008	118	6,630	1,709	866	61	7,557

2009	271	15,219	52	15,271
2010 and onwards	972	54,590	1,214	55,804

(1) July 1, 2005 through December 31, 2005.

U.S. Dollar Debt:

Export Credit Agencies-Supported Loans

In order to obtain imported components for our network infrastructure in connection with our expansion and service improvement programs, we obtained loans extended and/or guaranteed by various export credit agencies. These financings account for a significant portion of our indebtedness.

Kreditanstalt für Wiederaufbau, or KfW

KfW, a German state-owned development bank, is PLDT s largest single creditor. As at June 30, 2005, we owed US$306 million aggregate principal amount of debt to KfW, as follows:

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- US$227 million provided under various export credit agency-backed facilities, of which US$117 million was in connection with our expansion and service improvement programs and US$110 million in connection with the US$149 million refinancing facility discussed below; and

- US$79 million provided for the 15% downpayment portion and credit facilities without guarantee/insurance cover from the export credit agencies, of which US$30 million was in connection with the US$149 million refinancing facility discussed in the following paragraphs.

On January 25, 2002, PLDT signed two loan agreements with KfW, which provided PLDT with a US$149 million facility to refinance in part the repayment installments under its existing loans from KfW due from January 2002 to December 2004. The facility is composed of a nine-year loan, inclusive of a three-year disbursement period and a two-year grace period during which no principal is payable. It partly enjoys the guarantee of HERMES, the export credit agency of the Federal Republic of Germany. We have drawn US$140 million (Php7,862 million) under this facility as at June 30, 2005. PLDT waived further disbursements under this refinancing facility effective September 1, 2004. Thus, the undrawn portion of US$9 million was cancelled.

Of the amounts outstanding under these KfW loans, US$38 million of our KfW loans will mature in 2005, US$57 million in 2006, US$78 million in 2007, US$58 million in 2008, US$44 million in 2009 and US$31 million in 2010. Principal amortizations on these loans are generally payable in equal semi-annual installments.

Finnish Export Credit, plc, or Finnvera

As at June 30, 2005, US$139 million aggregate principal amount of Smart s debts were provided by various banks under export credit agency-backed facilities in connection with Smart s GSM expansion programs. These facilities are covered by guarantees from Finnvera, the Finnish export credit agency, for 95% of political risk and 50% of commercial risk for GSM Phase 1 to 4 loan facilities and 100% of political and commercial risk for the refinancing facility of GSM Phase 5A and 5B. The US$100 million refinancing facility was obtained on February 11, 2005 in relation to Smart s GSM Phase 5A and 5B loans which were prepaid last March 1, 2005 with outstanding balances of US$60 million and US$41 million, respectively, at the time of prepayment. This refinancing facility is payable semi-annually over five years starting September 1, 2005 with final repayment due in March 2010. The principal benefit of refinancing the Phase 5 loan was the savings from a lower interest margin on the refinancing facility.

Of the amounts outstanding under these Finnvera guaranteed loans, US$32 million will mature in 2005, US$37 million in 2006, US$20 million in 2007, US$20 million in 2008, US$20 million in 2009 and US$10 million in 2010. Principal amortization on these loans are generally payable in equal semi-annual installments.

Nippon Export and Investment Insurance of Japan, or NEXI

On November 28, 2002, Smart signed a US$100 million term loan facility supported by NEXI, of which US$60 million was drawn on November 28, 2003 and US$40 million on April 5, 2004. This loan is payable semi-annually over four years in eight equal installments starting May 28, 2004 with final repayment due in November 2007. Outstanding balance as at June 30, 2005 is US$63 million.

Japan Bank for International Cooperation, or JBIC/Co-financing Banks

As at June 30, 2005, PLDT owed US$29 million aggregate principal amount of debt to JBIC (formerly the Export-Import Bank of Japan) and its co-financing banks under various facilities. Of the amounts outstanding under these loans, US$5 million will mature in 2005, US$10 million in 2006, US$8 million in 2007, US$3 million in 2008 and US$3 million in 2009.

Other Export Credit Agency Supported Loans

PLDT has also obtained loans extended and/or guaranteed by other export credit agencies, including the Export-Import Bank of the United States, and the respective export credit agencies of France, Italy, Israel, Sweden, Canada, Australia and Singapore, in the aggregate outstanding principal amount of US$45 million as at June 30, 2005. Smart, likewise, obtained loans guaranteed by export credit agencies of Norway and Italy amounting to US$6 million. Of the amounts outstanding under these loans, US$12 million will mature in 2005, US$19 million in 2006, US$13 million in 2007, US$4 million in 2008, US$2 million in 2009 and US$1 million in 2010.

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Fixed Rate Notes

PLDT has the following non-amortizing fixed rate notes outstanding as at June 30, 2005 and December 31, 2004:

Principal Amount	**Interest Rate**	**Maturity Date**	**June 30, 2005 (Unaudited)**		December 31, 2004 (Audited)	
			(in millions)			
US$300,000,000	8.350%	March 6, 2017	**US$296**	**Php16,616**	US$296	Php16,658
US$250,000,000	11.375%	May 15, 2012	**243**	**13,640**	242	13,661
US$161,799,000	7.850%	March 6, 2007	**161**	**9,057**	183	10,315
US$175,000,000	10.500%	April 15, 2009	**174**	**9,756**	174	9,777
US$119,389,000	9.250%	June 30, 2006	**119**	**6,691**	129	7,289
US$110,557,000	9.875%	August 1, 2005	**111**	**6,210**	110	6,223
US$ 73,766,000	10.625%	May 15, 2007	**72**	**4,073**	86	4,872
			US$1,176	**Php66,043**	US$1,220	Php68,795

Term Loans

US$283 Million Term Loan Facility, or Debt Exchange Facility

On July 2, 2004, Smart acquired from Piltel s creditors approximately US$289 million, or 69.4%, in the aggregate of Piltel s outstanding restructured debt at that time, in exchange for Smart debt and a cash payment by Smart. In particular, Smart paid an amount in cash of US$1.5 million, or Php84 million and issued new debt of US$283.2 million, or Php15,854 million, at fair value of Php8,390 million, net of debt discount amounting to Php7,464 million. As at June 30, 2005, unamortized discount amounted to Php85 million.

The breakdown of the total amount of Smart debt issued to participating Piltel creditors is as follows:

- 2007 Facility in the amount of US$0.2 million payable in full in December 2007;
- 2008 Facility in the amount of US$2.9 million payable in full in December 2008; and
- 2014 Facility in the amount of US$280.1 million payable in full in June 2014.

Interest for the above facilities is payable every quarter at a floating rate of three months US$ LIBOR plus 1.00% for the 2007 and 2008 facilities, and a fixed rate of 2.25% per annum for the 2014 facility. Furthermore, a portion of the 2014 facility amounting to US$144 million has a variable yield option whereby the creditors have an option to elect for an early repayment at a discount either in December 2007 at 52.5% of the relevant debt amount or in December 2008 at 57.5% of the relevant debt amount.

GSM Network Expansion Facilities

On September 13, 2004, Smart signed a US$104 million 5-year term loan facility supported by Finnish Export Credit Ltd. as the lender with ABN AMRO Bank, Banque National de Paribas, Calyon, DBS Bank and Sumitomo Mitsui Banking Corporation as the Lead Arrangers. The full amount of the facility was drawn in November 22, 2004, of which US$94 million remained outstanding as at June 30, 2005. The loan is payable over five years in ten equal payments starting May 2005 with final repayment in November 2009.

On June 8, 2001, Smart signed its GSM Phase 5A financing comprised of US$195 million loans, of which US$30 million is owed to Nordic Investment Bank, or NIB, US$15 million to Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO, of the Netherlands and US$150 million to Finnvera. Of the amounts owed to FMO and NIB, US$18 million remained outstanding as at June 30, 2005 with final repayments due in March 2007 and June 2007.

Local Exchange Transfer Loans

In connection with the transfer to PLDT of Smart s local exchange business, PLDT entered into loan agreements with Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO, of the Netherlands, Exportkreditnamden, or EKN, of Sweden and Export Credits Guarantee Department, or ECGD, of the United Kingdom for loans in the principal amounts of US$135 million, US$36 million and US$27 million, respectively. The FMO loan with original final maturity of September 1, 2007 was prepaid in full on March 1, 2005. The ECGD and EKN loans, both with original final maturity on December 31, 2007, were prepaid in full effective June 30, 2005.

Restructured Loans

On June 4, 2001, Piltel completed the restructuring of approximately Php41 billion of indebtedness and other claims owed to banks, trade creditors, bondholders and preferred shareholders, representing 98% of its total liabilities as at that date.

As a result of the restructuring:

a. 50% of the financial debt of each participating creditor was released in consideration for the allotment of Piltel Series K Class I Convertible Preferred Stock. One (1) Piltel Series K Class I Convertible Preferred Stock was exchanged for every Php340 worth of debt (converted into Pesos at an exchange rate of Php47.05 = US$1.00 for dollar-denominated debt and Php1.00 = JP¥2.39522 for yen-denominated debt), which shares were immediately and mandatorily converted into PLDT Convertible Preferred Stock. One PLDT Series V, VI or VII convertible preferred share was issued for every five (5) Piltel Series K Class I Convertible Preferred Stock.

b. Approximately half of the remaining 50% of all participating creditors (except for bondholders and preferred shareholders) financial debt became their participation in a Tranche B Loan in the same currency as their previous financial debt and the other half became their participation in a Tranche C Loan also in the same currency as their previous financial debt. In the case of bondholders and preferred shareholders, the remaining 50% of their financial debt became a participation in the Conversion Notes Facility and in a single Tranche Peso loan, or the Term Notes Facility, respectively.

On July 2, 2004, Smart acquired from Piltel s creditors US$289 million, or 69.4%, in the aggregate of Piltel s total outstanding restructured debt at that time, in exchange for US$283.2 million in new debt of Smart and US$1.5 million in cash. A gain on debt exchange transaction amounting to Php4,419 million was recognized in our consolidated statement of income representing the difference between the fair value of Piltel s debt cancelled and/or exchanged amounting to Php12,893 million (net of debt discount of Php3,359 million) and Smart s consideration for the debt exchange including cash of Php84 million (US$1.5 million) and fair value of newly issued debt amounting to Php8,390 million (net of debt discount of Php7,464 million). This portion of Piltel s debt has been eliminated in consolidation as at June 30, 2005.

Piltel s residual long-term debt to third parties consists of:

June 30, 2005

Description	(Unaudited)		December 31, 2004 (Audited)	
	(in millions)			
Restructured debts				
Philippine Pesos				
10 year Tranche B		**Php186**		Php182
15 year Tranche C		**185**		181
		371		363
U.S. Dollars				
10 year Tranche B	**US$7**	**414**	US$7	406
15 year Tranche C	**7**	**408**	7	400
15 year Conversion Notes Facility	**74**	**4,095**	71	4,009
	US$88	**4,917**	US$85	4,815
Total		**5,288**		5,178
Unrestructured debt				
U.S. Dollars				
Convertible bonds	**US$1**	**52**	US$1	52
Total		**5,340**		5,230
Less current portion		**75**		59
		Php5,265		Php5,171

The following is a summary of the key economic terms relating to the restructuring of the financial debt taking the form of Tranche B Loan, Tranche C Loan, Term Notes Facility and Conversion Notes Facility.

	Tranche B Loans	Tranche C Loans	Term Notes Facility	Conversion Notes Facility
Final maturity	10 years from June 4, 2001	15 years from June 4, 2001	15 years plus 10 days from June 4, 2001	15 years from June 4, 2001
Amortization	Years 1 and 2 0.00%	Years 1 and 2 0.00%	Years 1 and 2 0.00%	Years 1 and 2 0.00%
	Years 3 to 9 0.10%	Years 3 and 4 0.10%	Years 3 to 14 0.10%	Years 3 and 4 0.10%
	Year 10 99.30%	Year 5 2.00%	Year 15 98.80%	Year 5 1.05%
		Years 6 to 14 10.00%		Years 6 to 9 5.05%
		Year 15 7.80%		Year 10 54.65%
				Years 11 to 14 5.00%
				Year 15 3.90%
Interest rate	**Peso facility** Philippine 91-day treasury bill rate, or T-Bill Rate, or the average		181-day T-Bill Rate or the average of the 181-day T-Bill Rate and the 6-months PHIBOR, if 6-months PHIBOR is different from the T-Bill Rate by more	LIBOR for three-month deposits plus 1.00% p.a.

	of the 91-day T-Bill Rate and the 90-day Philippine inter-bank offered rate, or PHIBOR, if 90-day PHIBOR is different from the T-Bill Rate by more than 2.50%, plus 1.00% p.a. **U.S. dollar facilities** London interbank rate for U.S. dollar deposits, or LIBOR, for three-month U.S. dollar deposits plus 1.00% p.a. **Yen facility** LIBOR interbank rate for Yen deposits for three-month deposits plus 1.00% p.a.	than 2.50%, plus 1.00% p.a.		
Interest payment dates	Quarterly in arrears	Semi-annually		

Under the terms of Piltel s debt restructuring plan, PLDT issued a Letter of Support, or LOS, for the benefit of Piltel and its creditors under which PLDT has agreed to cover any funding shortfalls of Piltel up to a maximum amount of US$150 million less all amounts paid or committed to be paid to or on behalf of Piltel or any of its subsidiaries or affiliates on or after March 23, 2000. Under the LOS, PLDT is required to provide funding to Piltel in the event that the cash flow from Piltel s operations falls short of the amount required by it to discharge in full its obligations to any creditor of Piltel and all its operating and financing subsidiaries and affiliates. PLDT is subject to contractual restrictions limiting the amount of financial support it can provide to Piltel up to US$150 million. As at June 30, 2005 and December 31, 2004, the remaining undrawn balance available under the PLDT LOS is US$50 million, approximately Php2,823 million and Php2,831 million, respectively, due to prior investments made from March 23, 2000 to December 31, 2002 aggregating to US$100 million through PLDT s subscription to Series J Class I preferred shares of Piltel. There was no drawdown under the LOS in 2004.

Piltel s restructured obligations are secured by substantially all present and future assets of Piltel under the mortgage trust indenture, or MTI, dated June 4, 2001 between Piltel and Chase Manhattan Bank as security agent for the creditors, which established the security arrangements relating to the restructured debts. The participating creditors (other than the participating holders of the Peso Term Note Facility) will share equally in first ranking security, while non-participating creditors and the participating holders of the Peso Term Note Facility will share equally in second ranking security created under the MTI. Such mortgage was approved by at least two-thirds of Piltel s stockholders at its annual meeting on April 18, 2001 and the NTC on May 18, 2001.

Satellite Acquisition Loans

Mabuhay Satellite has an existing Credit Agreement with the Export-Import Bank of the United States, or Ex-Im Bank, to finance a portion of the cost of purchasing the Agila II Satellite. In 2003, Ex-Im Bank of the United States approved, in principle, the re-profiling of Mabuhay Satellite s US$42 million debt with them by extending the maturity of the loan by 1½ years to July 15, 2007 and reducing the interest rate by 1% to 5.6%. The revised repayment terms have been approved by the majority of the local creditor banks.

Mabuhay Satellite also has an existing Omnibus Agreement with a syndicate of local banks, or the Banks, which includes issuance of irrevocable standby Letters of Credit with an aggregate stated value not exceeding US$39 million (Php2,171 million) in favor of U.S. Ex-Im Bank, as security under the Credit Agreement and a term loan to Mabuhay Satellite in the aggregate amount of US$26 million (Php1,465 million), which will mature on various dates from 2005 to 2007.

Mabuhay Satellite has constituted in favor of the Banks: (a) a first mortgage on its leasehold rights under a lease agreement entered into with the Subic Bay Metropolitan Authority and the components of the satellite system; (b) an assignment of its rights under its purchase contract for the satellite system; (c) an assignment of its rights under the transponder lease contracts to be entered into with its shareholders and other parties and the revenues therefrom; and (d) an assignment of the applicable proceeds of insurance to be taken on the satellite system.

Japanese Yen Debt:

JBIC JP¥9,760 Million Overseas Investment Term Loan

On July 26, 2002, PLDT signed a loan agreement with JBIC for a credit facility of JP¥9,760 million under JBIC s OIL program. The loan, which was drawn on July 31, 2002, is being amortized semi-annually beginning March 21, 2005 and will mature on March 21, 2008.

NEXI Supported JP¥5,615 Million Syndicated Term Loan Facility

On June 11, 2003, PLDT signed a JP¥5,615 million syndicated term loan facility supported by NEXI, of which JP¥2,520 million was drawn and JP¥1,890 million was outstanding as at June 30, 2005. The undrawn balance of JP¥3,095 million was cancelled at the end of the Availability Period on December 3, 2004. This loan is being amortized semi-annually beginning December 2004 and will mature in June 2008.

Philippine Peso Debt:

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Php2,770 Million Peso Fixed Rate Corporate Notes

In connection with PLDT s service improvement and expansion programs, PLDT has entered into two loan agreements, pursuant to each of which PLDT issued fixed rate corporate notes in three tranches. Interest on each tranche is payable semi-annually.

Under the first loan agreement, PLDT borrowed an aggregate amount of Php1,500 million, of which Php230 million matured on November 11, 2002, Php500 million matured on November 9, 2004 and Php770 million will mature on November 9, 2006.

Under the second loan agreement, PLDT borrowed an aggregate amount of Php1,270 million, of which Php360 million matured on June 9, 2003, Php100 million matured on June 9, 2005 and Php810 million will mature on June 9, 2010.

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Term Loans

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JBIC 4 Program of the Development Bank of the Philippines

In connection with the Asia Pacific Cable Network 2 project, PLDT entered into a loan agreement on September 28, 2000 with Citibank, N.A., as facility agent, and a syndicate of banks in the aggregate principal amount of Php1,700 million, of which about Php340 million was outstanding as at June 30, 2005. The loan, which was funded under the JBIC Facility for Private Sector Development of the Development Bank of the Philippines, matures on October 26, 2005 and since April 2002 is payable in quarterly installments as set forth below:

Quarterly Payment Number	Percentage of Principal Payable on Each Quarterly Payment Date
Payments 1 7	3.500%
Payments 8 11	8.875%

Payments 12 15	10.000%

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Secured Term Loans

Php150 Million Term Loan Facility

On March 4, 2002, ePLDT entered into a three-year loan facility with Philippine Bank of Communications amounting to Php150 million. The loan facility was fully drawn on December 31, 2002 and payable in seven quarterly installments, with a grace period of one year, beginning year 2003. The quarterly principal payments of Php15 million started in June 2003 with a balloon payment of Php45 million in March 2005. Interest on this loan was equivalent to 91-day T-bill rate plus 4% per annum payable quarterly in arrears. The loan was secured by ePLDT s deed of assignment of receivables of a subsidiary from a foreign customer and an investment in an associate with an original cost of Php629 million. This loan was fully paid as at March 31, 2005.

Php100 Million Term Loan Facility

On March 15, 2004, ePLDT entered into another three-year term loan facility with Asia United Bank amounting to Php100 million for the payment of its outstanding short-term bank loan facility and for other working capital requirements. The loan facility was fully drawn as at December 31, 2004. The loan is to be repaid in nine equal quarterly installments starting March 2005 with final repayment in March 2007. Interest on the loan is equivalent to 90-day PHIBOR plus 3% per annum payable quarterly in arrears. The loan is secured by a Mortgage Trust Indenture Agreement, or MTIA, on a parcel of land with a carrying value of Php279 million as at December 31, 2004. As at June 30, 2005, the outstanding balance of this loan amounted to Php78 million, of which Php22 million will mature in 2005.

Php149 Million Term Loan Facility

As at June 30, 2005, Vocativ, a wholly-owned call center subsidiary of ePLDT, had an outstanding five-year term loan facility of Php129 million with Asia United Bank for the payment of its additional capital expenditures and working capital requirements. The loan is to be repaid in 14 equal quarterly installments starting April 2006 with final repayment in July 2009. Interest on the loan is equivalent to 90-day PHIBOR plus 3% per annum payable quarterly in arrears. The loan is secured by a Mortgage Participation Certificate against the MTIA between ePLDT and Asia United Bank Corporation Trust and Investments Group dated March 15, 2004 on a parcel of land, which excludes the buildings and improvements. In April 2005, Php20 million of the loan was pre-terminated.

Debt Covenants

Our debt instruments contain restrictive covenants, including covenants that could prohibit us from paying dividends on common stock under certain circumstances, and require us to comply with specified financial ratios and other financial tests, calculated in conformity with accounting principles generally accepted in the Philippines, at relevant measurement dates, principally at the end of each quarterly period. We have complied with all of our maintenance financial ratios as required under our loan covenants and other debt instruments. In addition, we are required to comply with certain financial ratios for the incurrence of capital expenditures in excess of US$10 million and incurrence of indebtedness.

The principal factors that can negatively affect our ability to comply with these financial ratios and other financial tests are depreciation of the Philippine peso relative to the U.S. dollar, poor operating performance of PLDT and its consolidated subsidiaries, impairment or similar charges in respect of investments or other long-lived assets that may be recognized by PLDT and its consolidated subsidiaries and increases in our interest expenses. Interest expense may increase as a result of various factors including issuance of new debt, the refinancing of lower cost indebtedness by higher cost indebtedness, depreciation of the Philippine peso, the lowering of PLDT s credit ratings or the credit ratings of the Philippines, increase in reference interest rates, and general market conditions. Since approximately 98% of PLDT s total consolidated debts are denominated in foreign currencies, principally in U.S. dollars, many of these financial ratios and other tests are negatively affected by any weakening of the peso.

PLDT s debt instruments contain a number of other negative covenants that, subject to certain exceptions and qualifications, restrict PLDT s ability to take certain actions without lenders approval, including: (a) incurring additional indebtedness; (b) prepaying other debt; (c) making investments; (d) extending loans; (e) extending guarantees or assuming the obligations of other persons; (f) paying dividends or other distributions or redeeming, repurchasing or otherwise acquiring shares of PLDT s capital stock; (g) disposing of all or substantially all of its assets or of assets in excess of specified thresholds of its tangible net worth; (h) entering into management contracts providing for the management of its business or operations by a third party; (i) creating any lien or security interest; (j) permitting set-off against amounts owed to PLDT; (k) merging or consolidating with any other company; (l) entering into transactions with stockholders and affiliates; and (m) entering into sale and leaseback transactions.

Further, certain of PLDT s debt instruments contain provisions wherein PLDT may be required to repurchase or prepay certain indebtedness in case of change in control of PLDT or if the ownership of our shares of common stock held by NTT Communications falls below a certain threshold.

PLDT s debt instruments also contain customary and other default provisions that permit the lender to accelerate amounts due or terminate their commitments to extend additional funds under the debt instruments. These default provisions include: (a) cross-defaults and cross-accelerations that permit a lender to declare a default if PLDT is in default under another debt instrument; in some cases, the cross-default provision is triggered upon a payment or other default permitting the acceleration of PLDT s debt, whether or not the defaulted debt is accelerated. In other cases, the cross-default provision requires the defaulted loan to be accelerated. In some debt instruments, the cross-default provision will be triggered only if the principal amount of the defaulted indebtedness exceeds a threshold amount specified in these debt instruments; (b) failure by PLDT to meet certain financial ratio covenants referred to above; (c) the occurrence of any material adverse change in circumstances that a lender reasonably believes materially impairs PLDT s ability to perform its obligations under its debt instrument with the lender; (d) the revocation, termination or amendment of any of the permits or franchises of PLDT in any manner unacceptable to the lender; (e) the abandonment, termination or amendment of the project financed by a loan in a manner unacceptable to the lender; (f) the nationalization or sustained discontinuance of all or a substantial portion of PLDT s business; and (g) other typical events of default, including the commencement of bankruptcy, insolvency, liquidation or winding up proceedings by PLDT.

Smart s debt instruments contain certain restrictive covenants, including covenants that prohibit Smart from paying dividends, redeeming preferred stock, making distributions to PLDT or otherwise providing funds to PLDT or any affiliate without the consent of its lenders under its Phases 1, 2 and 3 facilities. Also, Smart s debt instruments contain certain restrictive covenants that require Smart to comply with specified financial ratios and other financial tests at semi-annual measurement dates. The financial tests under Smart s loan agreements include compliance with a debt to equity ratio of not more than 1.50:1 and a debt service coverage ratio of not less than 1.50:1. Smart has maintained compliance with all of its financial covenants. The agreements also contain customary and other default provisions that permit the lender to accelerate amounts due under the loans or terminate their commitments to extend additional funds under the loans. These default provisions include: (a) cross-defaults and cross-accelerations that permit a lender to declare a default if Smart is in default under another loan agreement. These cross-default provisions are triggered upon a payment or other default permitting the acceleration of Smart debt, whether or not the defaulted debt is accelerated; (b) failure by Smart to comply with certain financial ratio covenants; (c) any reduction in PLDT s ownership of Smart s shares below 51%; (d) any reduction in First Pacific s and Metro Pacific Corporation s collective direct and/or indirect ownership of PLDT s common stock below 17.5% of the total common stock outstanding; and (e) the occurrence of any material adverse change in circumstances that the lender reasonably believes materially impairs Smart s ability to perform its obligations under its loan agreements.

As at June 30, 2005, Piltel was not in compliance with the terms of convertible bonds with principal amount of US$0.7 million (approximately US$0.9 million redemption price at the option of the holders). Piltel may not be able to restructure or otherwise pay the claims of its unrestructured debt. However, default on and acceleration of Piltel s unrestructured indebtedness does not create a cross-default under Piltel s restructured indebtedness or any indebtedness of PLDT or Smart.

The Credit and Omnibus Agreements of Mabuhay Satellite imposes several negative covenants. In particular, these covenants, among others, restrict material changes in Mabuhay Satellite s nature of business and ownership structure, any lien upon or with respect to any of its assets or to any right to receive income, acquisition of capital stock, declaration and payment of dividends, merger, consolidation and sale with another entity and incurring or guaranteeing additional long-term debt beyond prescribed amounts.

ePLDT s loan agreement imposes negative covenants which, among other things, restrict ePLDT in regard to payment of cash dividends or any other income or any capital distribution to PLDT, voluntary suspension of its entire business operations for a period of 60 consecutive days, dissolution of its legal existence, and creation of any encumbrances on the shares pledged. One of ePLDT s loan agreements also requires ePLDT to comply with specified financial ratios and other financial tests at quarterly measurement dates. The agreement also contains customary and other default provisions that permit the lender to accelerate amounts due under the loan or terminate their commitments to extend additional funds under the loan. As at June 30, 2005, ePLDT has complied with all of its financial covenants.

Obligations Under Capital Lease

The future minimum payments for capitalized leases are as follows as at June 30, 2005:

Year	**(Unaudited)**
	(in million pesos)
2005(1)	535
2006	431
2007	317
2008	8
2009	7
2010 and onwards	444
Total minimum lease payments	1,742
Less amount representing interest	699
Present value of net minimum lease payments	1,043
Less capital lease maturing within one year	527
Long-term portion of obligations under capital lease	516

(1) July 1, 2005 through December 31, 2005.

Municipal Telephone Projects

In 1993, PLDT entered into two lease agreements with the Philippine Department of Transportation and Communications, or DOTC, covering telecommunications facilities in Bohol and Batangas established under the Municipal Telephone Act. Under these agreements, PLDT was granted the exclusive right to perform telecommunications management services, to expand services, and to promote the use of the DOTC-contracted facilities in certain covered areas for a period of 15 years. Title to the properties shall be transferred to PLDT upon expiration of the lease term. As at June 30, 2005, PLDT s aggregate remaining obligation under this agreement was approximately Php858 million. In case of cancellation, PLDT is liable to pay Php100 million under each of the two contracts as liquidated damages.

On June 1, 2004, PLDT served the DOTC a notice of termination of the lease agreement in respect of the telecommunications system in Bohol which state of deterioration, obsolescence and disrepair have made it impossible for PLDT to continue managing, operating, and maintaining the system. Since 2002, PLDT has been advising the

DOTC of the need to review the viability of the system as it has infused more than Php200 million for upgrades and maintenance to keep the system operable. Further, the enactment of Public Telecommunications Policy Act, or R.A. No. 7925, which negated the DOTC s warranty to grant PLDT the exclusive right to provide telecommunication services in the areas stipulated, prevented PLDT from achieving the originally projected profitability thereby rendering it impossible for PLDT to continue fulfilling its obligation under the lease agreement. Although several discussions have been held since then to seek a mutually acceptable agreement, no amenable arrangement has been reached. On June 30, 2004, the DOTC advised PLDT that the request for termination of the lease agreement in Bohol has been referred to the Department of Justice, or DOJ, as government agencies are required to refer all interpretation of contracts and agreements to the DOJ secretary as attorney-general of the national government. On May 5, 2005, PLDT received a letter from the DOTC stating that PLDT is in default for failure to remit to the DOTC the quarterly installments under the lease agreement. PLDT is intending to bring the matter to Arbitration for the Financial Lease Agreement due to clearing opposing positions of the parties. As at June 30, 2005, the net book value of the telecommunications system in Bohol, including PLDT s additional capital expenditure relating to the telecommunications system, and corresponding capital lease obligation amounted to Php35 million and Php735 million, respectively.

Other Long-term Capital Lease Obligations

The PLDT Group has various long-term lease contracts for a period of three years covering various office equipment. In particular, Smart and Piltel have capital lease obligations aggregating Php469 million as at June 30, 2005 in respect of office equipment and facilities.

Under the terms of certain loan agreements and other debt instruments, PLDT may not create, incur, assume or permit or suffer to exist any mortgage, pledge, lien or other encumbrance or security interest over the whole or any part of its assets or revenues or suffer to exist any obligation as lessee for the rental or hire of real or personal property in connection with any sale and leaseback transaction.

Preferred Stock Subject to Mandatory Redemption

The movements of PLDT s preferred stock subject to mandatory redemption follow:

	June 30, 2005 (Unaudited)				December 31, 2004 (Audited)			
	Series V	**Series VI**	**Series VII**	**Total**	Series V	Series VI	Series VII	Total
	(in million pesos)							
Balance at beginning of period	**2,104**	**6,242**	**6,029**	**14,375**	2,053	5,435	5,247	12,735
Conversion	**(945)**	**(80)**		**(1,025)**	(339)	(18)		(357)
Accretion	**180**	**413**	**152**	**745**	390	751	457	1,598
Revaluation		**(11)**	**(473)**	**(484)**		74	325	399
Balance at end of period	**1,339**	**6,564**	**5,708**	**13,611**	2,104	6,242	6,029	14,375

As at June 30, 2005, PLDT had issued 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel adopted in June 2001. Shares of Series V, VI and VII Convertible Preferred Stock are entitled to receive annual dividends of Php18.70 per share, US$0.397 per share and JP¥40.7189 per share, respectively. Each share of Series V, VI and VII Convertible Preferred Stock is convertible at any time at the option of the holder into one PLDT common share. On the date immediately following the seventh anniversary of the issue date of the Series V and Series VI Convertible Preferred Stock and on the eighth anniversary of the issue date of the Series VII Convertible Preferred Stock, the remaining outstanding shares under these series will be mandatorily converted to PLDT common shares. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion of the Series V, VI and VII Convertible Preferred Stock will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JPY4,071.89 per share, respectively.

The Series V, VI and VII Convertible Preferred Stock were designated as compound instruments consisting of liability and equity components. The total fair value of the Series V, VI and VII Convertible Preferred Stock was determined at issue date, of which the aggregate fair value of the liability component of the issued Series V, VI and VII Convertible Preferred Stock as at date of issuance is included under the Interest-bearing Financial Liabilities account in the consolidated balance sheets. The residual amount was assigned as the equity component.

The difference between the aggregate fair value of the Series V, VI and VII Convertible Preferred Stock at issue date and the aggregate redemption value is accreted over the period up to the put option date using the effective interest rate method. Accretions added to Preferred Stock Subject to Mandatory Redemption and charged to interest for the six months ended June 30, 2005 and 2004 amounted to Php745 million and Php756 million, respectively.

Preferred Stock Subject to Mandatory Redemption amounted to Php13,611 million and Php14,375 million as at June 30, 2005 and December 31, 2004, respectively, after revaluation of Series VI and VII Convertible Preferred Stock to the exchange rates at balance sheet dates and after giving effect to the above accretions, conversions and additional issuances. As at June 30, 2005 and December 31, 2004, 2,040,354 shares and 1,060,940 shares, respectively, of the Convertible Preferred Stock have been converted into PLDT common shares. The outstanding shares of Series V, VI and VII Convertible Preferred Stock as at June 30, 2005 were 1,285,535, 4,690,655 and 3,842,000, respectively. The aggregate redemption value of the outstanding Series V, VI and VII Convertible Preferred Stock amounted to Php19,633 million and Php22,016 million as at June 30, 2005 and December 31, 2004, respectively.

The corresponding dividends on these shares charged as interest expense amounted to Php132 million and Php117 million for the six months ended June 30, 2005 and 2004, respectively.

Notes Payable

Parlance, a wholly-owned call center subsidiary of ePLDT, has availed of a local bank s Export Packing and Credit Loan facility amounting to US$950,000 in December 2004 and another in June 2005 amounting to US$1 million. The said facilities can be availed by an export Letter of Credit with an 80% loan value. It has a 90-day term from the date it was granted by the bank and is supported by a Deed of Assignment of Receivables. Interest is based on the prevailing bank rate to be collected in arrears on a monthly basis. The US$950,000 loan facility was fully paid in March 2005.

18. Other Noncurrent Liabilities

This account consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Capital expenditures under long-term financing	**5,786**	3,970
Prepayment received under receivable purchase facility (Note 14)	**1,269**	1,644
Asset retirement obligations (Note 8)	**709**	638
Unearned revenues	**86**	85
Others	**791**	822
	8,641	7,159

19. Accrued Expenses and Other Current Liabilities

This account consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Accrued utilities and related expenses	**5,727**	4,457
Accrued taxes and related expenses	**2,582**	2,886
Accrued interest on various loans (Notes 17 and 20)	**2,142**	2,235

Accrual for payment for unused sick leave and other employee benefits	**1,663**	1,624
Payable in installment purchase of equity investment	**1,343**	1,561
Others	**2,647**	2,048
	16,104	14,811

20. Related Party Transactions

a. Air Time Purchase Agreement between PLDT and AIL and Related Agreements

In March 1997, PLDT entered into a National Service Provider, or Founder NSP, Air Time Purchase Agreement with PT Asia Cellular Satellite, as amended in December 1998 and as assigned and transferred to AIL, under which PLDT was granted the exclusive right to sell ACeS services in the Philippines. In exchange, the Air Time Purchase Agreement required PLDT to purchase from PT Asia Cellular Satellite at least US$5 million worth of air time annually over ten years, commencing on January 1, 2002, the date of commercial operations.

In the event that PT Asia Cellular Satellite s aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement states that PLDT has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term.

PLDT and the other founder NSPs are endeavoring to amend the Air Time Purchase Agreement due to the occurrence of partial satellite loss, changes in the primary business of ACeS and other events affecting the business.

In March 2003, PLDT, together with the other founder NSPs, entered into a Standstill Agreement with AIL suspending the application and enforcement of the minimum and supplemental air time payments under the original Air Time Purchase Agreement. The parties agreed that AIL shall provide PLDT and the other founder shareholders, with unlimited use of air time for the year 2003 in exchange for a fixed fee in the amount of US$3.8 million for PLDT. Moreover, PLDT was also obliged to purchase from AIL 13,750 satellite phone units in 2003 at US$395 F.O.B. per unit, subject to quarterly price adjustments. The parties to the Standstill Agreement also agreed to negotiate in good faith and use their best efforts to reach an agreement on a revised Air Time Purchase Agreement before November 15, 2003 that will cover, among other things, the amended minimum and supplemental air time payment provisions subject to the approval of AIL s creditors.

On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement effective January 1, 2002, following the lapse of the November 15, 2003 deadline set in the Standstill Agreement for the negotiation of a revised Air Time Purchase Agreement. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. As at June 30, 2005, PLDT s outstanding payables under the original Air Time Purchase Agreement was Php4,068 million. See *Note 22 Contractual Obligations and Commercial Commitments* and *Note 23 Provisions and Contingencies* for further discussion.

PLDT also entered into a Founder NSP Operating Agreement with PT Asia Cellular Satellite on March 12, 1997, under which PLDT may:

- authorize distributors to resell ACeS services in the Philippines upon prior approval from PT Asia Cellular Satellite; and

- appoint agents to solicit and bill PLDT s or its authorized distributors subscribers for ACeS services and to sell terminals on behalf of PLDT.

Under an Assignment and Assumption Agreement dated December 29, 1998, PT Asia Cellular Satellite agreed to assign and transfer to AIL of PT Asia Cellular Satellite s rights under the Founder NSP Air Time Purchase Agreement and Founder NSP Operating Agreement.

Under an Acknowledgment of the Assignment of Air Time Purchase Agreement entered into on December 29, 1998, by and among PLDT, P.T. Bank Internasional Indonesia and AIL, PLDT consented to the assignment by AIL of the Founder NSP Air Time Purchase Agreement to P.T. Bank Internasional Indonesia, as security agent, for the benefit of the secured parties under the Security Agreement dated December 29, 1998, which was executed in connection with the Amended and Restated Credit Agreement dated December 29, 1998 among PT Asia Cellular Satellite, AIL, P.T. Bank Internasional Indonesia and various banks.

On September 30, 2002, PT Asia Cellular Satellite, AIL, as guarantor, P.T. Bank Internasional Indonesia, as security agent, and various other banks signed a Rescheduling Agreement, which amended the terms of the Amended and Restated Credit Agreement dated December 29, 1998, moving the principal repayment dates to agreed periods with the final maturity date on January 30, 2012.

b. Transactions with Major Stockholders, Directors and Officers

Transactions to which PLDT or its subsidiaries is a party, in which a director or key officer or owner of more than 10% of the common stock of PLDT, or any member of the immediate family of a director or key officer or owner of more than 10% of the common shares of PLDT had a direct or indirect material interest in PLDT or its subsidiary, as at June 30, 2005 and December 31, 2004 and for the six months ended June 30, 2005 and 2004 are as follows:

1. Agreements with NTT Communications and/or its Affiliates

PLDT is a party to the following agreements with NTT Communications and/or its affiliates:

• *Advisory Services Agreement*. On March 24, 2000, PLDT entered into an agreement with NTT Communications, as amended on December 31, 2003, under which NTT Communications provides PLDT with technical, marketing and other consultants for various business areas of PLDT starting April 1, 2000;

• *Domestic Fiber Optic Network Submerged Plant Maintenance Agreement*. On July 4, 2000, PLDT entered into an agreement with NTT World Engineering Marine Corporation, or NTT WEMC, for submarine cable repair and other related services for the maintenance of PLDT s domestic fiber-optic network, or DFON, submerged plant for a period of five years up to July 4, 2005. This agreement has been extended up to the end of 2005. Under the agreement, PLDT is required to pay NTT WEMC a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair;

• *Arcstar Licensing Agreement and Arcstar Service Provider Agreement.* On March 24, 2000, PLDT entered into an agreement with NTT Worldwide Telecommunications Corporation under which PLDT markets managed data and other services under NTT Communications Arcstar brand to its corporate customers in the Philippines. PLDT also entered into a Trade Name and Trademark Agreement with NTT Communications under which PLDT has been given the right to use the tradename Arcstar and its related trademark, logo and symbols, solely for the purpose of PLDT s marketing, promotional and sales activities for the Arcstar services within the Philippines; and

• *Conventional International Telecommunications Services Agreement*. On March 24, 2000, PLDT entered into an agreement with NTT Communications under which PLDT and NTT Communications agreed to cooperative arrangements for conventional international telecommunications services to enhance their respective international businesses.

Total fees under these agreements amounted to Php114 million and Php146 million for the six months ended June 30, 2005 and 2004, respectively. As at June 30, 2005 and December 31, 2004, outstanding obligations of PLDT amounted to Php55 million and Php49 million, respectively.

2. Agreement between Smart and Asia Link B.V., or ALBV. Smart has an existing Technical Assistance Agreement with ALBV for the latter to provide technical support services and assistance in the operations and maintenance of cellular business for a period of five years, subject to renewal upon mutual agreement between the parties. The agreement provides for quarterly payments of technical service fees equivalent to 2% of the net revenues of Smart. In January 2004, the agreement was amended, reducing the technical service fees to be paid by Smart to ALBV to 1% of net revenues effective January 1, 2004. On February 18, 2004, Smart and ALBV entered into a renewal of the technical service agreement extending the effectivity of the terms of the agreement to February 23, 2008. Furthermore, in view of the acquisition by Smart of Piltel Series K Class I Convertible Preferred Stock held by PLDT, the parties agreed to make the consolidated net revenues of Smart the basis for the computation of the 1% royalty payable by Smart to ALBV, effective from January 1, 2005.

Smart also has an existing Services Agreement with ALBV for a period of 25 years starting January 1, 1999, which shall automatically expire unless renewed by mutual agreement of both parties. Under the agreement, ALBV provides advice and assistance to Smart in sourcing capital equipment and negotiating with international suppliers, arranging international financing and other services therein consistent with and for the furtherance of the objectives of the services. Service agreement fees were paid for the whole 25-year period.

ALBV is a subsidiary of the First Pacific Group.

Total fees under these agreements amounted to Php278 million and Php239 million for the six months ended June 30, 2005 and 2004, respectively. Outstanding obligations of Smart under the Technical Service Agreement amounted to Php284 million and Php267 million as at June 30, 2005 and December 31, 2004, respectively.

3. Agreements relating to insurance companies. Gotuaco del Rosario and Associates, or Gotuaco, acts as the broker for certain insurance companies to cover certain properties of the PLDT Group. Insurance premiums are remitted to Gotuaco and the broker s fees are settled between Gotuaco and the insurance companies. In addition, PLDT has an insurance policy with Malayan Insurance Co., Inc., or Malayan, wherein premiums are directly paid to Malayan. Total insurance expenses under these agreements amounted to Php268 million and Php238 million for the six months ended June 30, 2005 and 2004, respectively. Two directors of PLDT have a direct/indirect interests in or serve as director/officer of Gotuaco and Malayan.

Compensation of Key Management Personnel of the PLDT Group

The aggregate compensation and benefits paid to the chief executive officer and other key officers and advisors, as a group, for the six months ended June 30, 2005 and 2004 amounted to approximately Php403 million and Php307 million, respectively.

Each of the directors, including the members of the advisory board of PLDT, is entitled to a director s fee in the amount of Php125,000 for each meeting of the board attended, except Manuel V. Pangilinan, who has waived his right to receive a director s fee. Each of the members or advisors of the audit, executive compensation, governance and nomination and finance committees is entitled to a fee in the amount of Php50,000 for each committee meeting attended.

There are no agreements between PLDT and any of its directors and key officers and advisors providing for benefits upon termination of employment, except for such benefits to which they may be entitled under PLDT s retirement plan.

21. Employee Benefits

Executive Stock Option Plan, or ESOP

On April 27, 1999 and December 10, 1999, the Board of Directors and stockholders, respectively, approved the establishment of an ESOP and the amendment of the Seventh Article of the Articles of Incorporation of PLDT denying the pre-emptive right of holders of common stock to subscribe for any issue of up to 1,289,745 common stock pursuant to the ESOP. The ESOP covers management executives, which include officers with rank of Vice President up to the President, executives with the rank of Manager up to Assistant Vice President, and advisors/consultants engaged by PLDT. The ESOP seeks to motivate option holders to achieve PLDT s goals, reward option holders for the creation of shareholder value, align the option holders interests with those of the stockholders of PLDT and retain the option holders to serve the long-term interests of PLDT. The ESOP is administered by the Executive Compensation Committee of the Board of Directors. About 1.3 million common stock of PLDT have been reserved as underlying shares of options under the ESOP in 1999.

Movements in the number of stock option plan outstanding are as follows:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
Balance at beginning of period	**536,589**	900,118
Exercised shares*	**(168,961)**	(336,745)
Cancelled		(26,784)
Balance at end of period	**367,628**	536,589

** Based on date of payment of exercised shares.*

As at June 30, 2005, 505,706 shares were exercised by certain officers and executives at an exercise price of Php814 per share. Of the 505,706 exercised shares, 7,798 shares were unissued as at June 30, 2005.

The fair value of the ESOP plan was estimated at the date of grant using an option pricing model, which considered annual volatility of 40%, risk-free interest rate, expected life of option, exercise share price of Php814 and weighted average share price Php870 for the 1999 Grant and Php315 for the 2002 Grant as at valuation date. Total fair value of shares granted amounted to Php359 million as at June 30, 2005 and December 31, 2004. The fair value of the options recognized as an expense for the six months ended June 30, 2005 amounted to Php8 million and none for the six months ended June 30, 2005.

LTIP

On August 3, 2004, PLDT s Board of Directors approved the establishment of the LTIP for eligible key executive officers and advisors of PLDT and its subsidiaries, which is administered by the Executive Compensation Committee. The LTIP is a four-year cash plan covering the period January 1, 2004 to December 31, 2007. The LTIP awards payment at the end of the four-year period (without interim payments) is contingent upon the achievement of an approved target increase in PLDT s common share price by the end of the plan period and a cumulative consolidated net income target for the plan period. The target increase in the PLDT base share price, which is the average of the closing prices of PLDT shares ten trading days before or after December 31, 2003, is approximately 15% per annum compounded for the plan period.

The fair value of the LTIP was estimated using an option pricing model, which considered annual stock volatility, risk-free interest rate, expected life of option of four years and weighted average share price Php1,620 as at valuation date. The fair value of the options recognized as an expense for the six months ended June 30, 2005 and 2004 amounted to Php610 million and Php269 million, respectively.

Pension

Defined Benefit Plans

We have defined benefit pension plans, covering substantially all of our permanent and regular employees, except Smart, which require contributions to be made to separate administrative fund.

Our actuarial valuation is done on an annual basis. Based on the latest actuarial valuation, the actual present value of accrued liability, net of pension cost and average assumptions used in developing the valuation are as follows:

	(in million pesos)
Benefit obligation as at December 31, 2004	6,925
Fair value of plan assets as at December 31, 2004	4,449
Funded status	2,476
Unrealized net transition obligation	(120)
Unrecognized net actuarial gain	(176)
Accrued benefit cost as at December 31, 2004	2,180
Accrual of pension cost during the period	384
Contributions	(157)
Accrued benefit cost as at June 30, 2005	2,407

Net pension cost was computed as follows:

	Six Months Ended June 30,	
	2005	2004
	(Unaudited) (in million pesos)	
Components of net periodic benefit cost:		
Service cost	**223**	213
Interest cost	**345**	269
Actual return on plan assets	**(238)**	(188)
Amortizations of unrecognized net transition obligation	**28**	28
Recognition of transitional liability	**2**	2
Net periodic benefit cost	**360**	324

The weighted average assumptions used to determine pension benefits are as follows:

Discount rate	9%
Rate of increase in compensation	7%
Rate of return on plan assets	9%

As at June 30, 2005, our plan assets include investments in shares of stock of PLDT and Piltel with fair values aggregating Php1,488 million, which represent about 23% of our beneficial trust fund s net assets available for plan benefits.

Defined Contribution Plan

Smart maintains a trustee-managed, tax-qualified, multi-employer plan covering substantially all permanent and regular employees. The plan has a defined contribution format wherein Smart s obligation is limited to specified contribution to the plan. It is being financed by the participating companies (Smart and its subsidiary, I-Contacts, Inc.) and employees contribution is optional.

	Six Months Ended June 30,	
	2005	2004
	(Unaudited)	
	(in million pesos)	
Expense recognized for defined benefit plans	**360**	324
Expense recognized for defined contribution plan	**24**	43
	384	367

22. Contractual Obligations and Commercial Commitments

Contractual Obligations

The following table discloses our contractual obligations outstanding as at June 30, 2005:

	Payments Due by Period				
	Total	**Within 1 year**	**2-3**	**4-5**	**After 5 years**

			years	years	
			(in million pesos)		
Long-term debt(1)	141,468	29,036	38,385	21,173	52,874
Long-term lease obligations:					
Operating lease	3,704	624	1,103	843	1,134
Capital lease	1,742	760	524	13	445
Unconditional purchase obligations(2)	11,861	4,556	2,249	2,247	2,809
Other long-term obligations	19,633		5,853	13,780	
Total contractual obligations	**178,408**	**34,976**	**48,114**	**38,056**	**57,262**

(1) Before deducting unamortized debt discount and debt issuance costs.

(2) Based on the original Air Time Purchase Agreement with AIL.

Long-term Debt

For a discussion of our long-term debt, see *Note 17 Interest-bearing Financial Liabilities*.

Long-term Operating Lease Obligations

Domestic Fiber Optic Network Submerged Plant Maintenance Agreement. As discussed in *Note 20 Related Party Transactions*, PLDT entered into an agreement with NTT World Engineering Marine Corporation, or NTT WEMC, on July 4, 2000, for submarine cable repair and other related services in relation to the maintenance of PLDT s DFON submerged plant for a period of five years up to July 4, 2005. This agreement has been extended up to the end of 2005. Under this agreement, PLDT is required to pay NTT WEMC a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely-operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair. As at June 30, 2005, PLDT s aggregate remaining obligation under this agreement was approximately Php39 million.

Digital Passage Service Contracts. PLDT has existing Digital Passage Service Contracts with foreign telecommunication administrations for several dedicated circuits to various destinations for ten to 25 years expiring at various dates. As at June 30, 2005, PLDT s aggregate remaining obligation under these contracts amounted to approximately Php24 million.

License Agreement with Mobius Management Systems (Australia) Pty Ltd., or Mobius. PLDT entered into a license agreement with Mobius pursuant to which Mobius has granted PLDT a non-exclusive, non-assignable and non-transferable license for the use of computer software components. Under this agreement, Mobius is also required to provide maintenance services for a period of one year at no additional maintenance charge. PLDT may purchase maintenance services upon expiration of the first year for a fee of 15% of the current published license fee. As at June 30, 2005, PLDT s aggregate remaining obligation under this agreement was approximately Php40 million.

Other Long-term Operating Lease Obligations. The PLDT Group has various long-term lease contracts for periods ranging from two to ten years covering certain offices, warehouses, cell sites telecommunication equipment locations and various office equipment. In particular, Smart has lease obligations aggregating Php3,325 million as at June 30, 2005 in respect of office and cell site rentals with over 3,000 lessors nationwide, PLDT has lease obligations aggregating Php96 million as at June 30, 2005, and ePLDT has lease obligations aggregating Php180 million as at June 30, 2005 in respect of certain office space rentals.

Long-term Capital Lease Obligations

For a discussion of our long-term capital lease obligations, see *Note 17 Interest-bearing Financial Liabilities*.

Unconditional Purchase Obligations

Air Time Purchase Agreement with AIL. As discussed in *Note 20 Related Party Transactions*, PLDT is a party to a Founder NSP Air Time Purchase Agreement with AIL in March 1997, which was amended in December 1998, under which PLDT is granted the exclusive right to sell AIL services in the Philippines. In exchange, the Air Time Purchase Agreement required PLDT to purchase from AIL a minimum of US$5 million worth of air time annually over ten years commencing on January 1, 2002, the date of commercial operations of the Garuda I Satellite.

In the event that AIL s aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement also states that PLDT has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term.

PLDT and the other founder NSPs are endeavoring to amend the Air Time Purchase Agreement due to the occurrence of partial satellite loss, changes in the primary business of ACeS and other events affecting the business.

In March 2003, PLDT, together with the other founder NSPs, entered into a Standstill Agreement with AIL suspending the application and enforcement of the minimum and supplemental air time payments under the original Air Time Purchase Agreement. The parties agreed that AIL shall provide PLDT and the other founder shareholders, with unlimited use of air time for the year 2003 in exchange for a fixed fee in the amount of US$3.8 million for

PLDT. Moreover, PLDT is also obliged to purchase from AIL 13,750 satellite phone units in 2003 at US$395 F.O.B. per unit, subject to quarterly price adjustments. The parties to the Standstill Agreement also agreed to negotiate in good faith and use their best efforts to reach an agreement on a revised Air Time Purchase Agreement before November 15, 2003 that will cover, among other things, the amended minimum and supplemental air time payment provisions subject to the approval of AIL s creditors.

On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement effective January 1, 2002 following the lapse of the November 15, 2003 deadline set in the Standstill Agreement for the negotiation of a revised Air Time Purchase Agreement. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. See *Note 20 Related Party Transactions* and *Note 23 Provisions and Contingencies* for further details relating to the Air Time Purchase Agreement with AIL.

As at June 30, 2005, PLDT s aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,857 million.

International Affiliate Agreement with VeriSign, Inc., or VeriSign. On September 15, 2000, ePLDT entered into an agreement with VeriSign for the non-exclusive, non-transferable right and license to use the VeriSign software, brand and Certification Practice Statement for the purpose of approving, issuing, suspending or revoking digital certificates for users of the internet or similar open systems in the Philippines for a period of seven years. Under this agreement, ePLDT is required to pay VeriSign a certain percentage of the revenue derived from the services subject to minimum annual royalty payments aggregating to US$11 million, which was subsequently reduced to US$1 million, for the seven-year contract period. In addition, ePLDT was required to pay an annual support fee of US$0.5 million during the first year and US$0.3 million in each year thereafter.

Effective July 1, 2003, VeriSign has agreed to amend the Agreement and issued Addendum 6 to write-off all past due invoices and payments owed to VeriSign, which were invoiced or scheduled to be invoiced under the agreement prior to this Addendum 6. All royalty payments and annual support fees due through June 2003 were part of the write-off in the amount of US$0.8 million. For contract year 4 (September 2003 to August 2004), the annual support fee was reduced from US$0.3 million to US$40,000 and for contract years 5 to 7 (September 2004 to August 2007) from US$0.3 million to US$0.16 million. In addition, VeriSign agreed to reduce the affiliate revenue sharing rates from 50% of suggested retail price to 25% of suggested retail price for both enterprise and internet products for 12 months starting July 2003 and negotiable thereafter.

Moreover, effective July 1, 2004, VeriSign has agreed to amend the Agreement and issued Addendum 8 as an extension of Addendum 6. Under this amendment, annual support fee for year 5 (September 2004 to August 2005) will remain at US$40,000 and affiliate revenue sharing rates will remain at 25%. As at June 30, 2005, ePLDT s aggregate remaining minimum obligation under this agreement was approximately Php4 million pertaining to annual support fee.

License Purchase Agreement with I-Contact Solutions Pte. Ltd. On April 2, 2003, iPlus is a wholly-owned subsidiary of ePLDT and the Philippines pioneer in IP-based IT response center, entered into an Application Services Provider, or ASP, and Reseller Contract with I-Contact Solutions Pte. Ltd., or I-Contact, of Singapore. Under the agreement, iPlus will purchase licenses of the CosmoCall Universe IP-based contact center solution. CosmoCall Universe supports multi-channel customer interactions including telephone, web chat, web voice, web video, web collaboration, e-mail and voicemail in one high capacity, high availability, multi-tenant platform. CosmoCall Universe is a complete, unified contact center suite that includes ACD, IVR, CTI, predictive dialing, multimedia recording and a complement of other management applications. The aggregate value of these licenses is US$2.1 million and these licenses will be delivered quarterly over a two-year period. Further to the agreement, I-Contact will appoint iPlus as the exclusive reseller and ASP for the Philippine market and will provide iPlus with all the necessary support in terms of sales, marketing, and technical services. Effective March 30, 2004, I-Contact has agreed to amend the agreement and waived all financial obligations and committed seats requirement over the two-year period. iPlus will pay all its remaining obligations pertaining only to the 300 seats delivered by I-Contact. In June 2005, iPlus committed to purchase additional 50 predictive dialer and Cosmocorder licenses in the amount of Php18 million.

Other Long-term Obligations

Mandatory Conversion and Purchase of Shares. As discussed in *Note 9 Investments in Associates* and *Note 17 Interest-bearing Financial Liabilities*, as at June 30, 2005, PLDT had issued a total of 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for a total of 58 million shares of Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel adopted in June 2004.

Each share of Series V, VI and VII Convertible Preferred Stock is convertible at any time at the option of the holder into one PLDT common share. On the date immediately following the seventh anniversary of the issue date of the Series V and Series VI Convertible Preferred Stocks and on the eighth anniversary of the issue date of the Series VII Convertible Preferred Stock, the remaining outstanding shares under these series will be mandatorily converted to PLDT common shares. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion of the Series V, VI and VII Convertible Preferred Stock will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JPY4,071.89 per share, respectively.

As at June 30, 2005, 1,435,905 shares of Series V Convertible Preferred Stock and 604,449 shares of Series VI Convertible Preferred Stock had been converted to PLDT common shares. The aggregate value of the put option based on outstanding shares as at June 30, 2005 was Php19,633 million, of which Php11,706 million is payable on June 4, 2008 and Php7,927 million on June 4, 2009, if all of the outstanding shares of Series V, VI and VII Convertible Preferred Stock were mandatorily converted and all the underlying common shares were put to PLDT. As at June 30, 2005, 1,285,535 shares of Series V, 4,690,655 shares of Series VI and 3,842,000 shares of Series VII Convertible Preferred Stock remain outstanding. The market value of the underlying shares of common stock was Php13,549 million, based on the market price of PLDT common shares of Php1,620 per share as at June 30, 2005.

Commercial Commitments

As at June 30, 2005, our outstanding commercial commitments, in the form of letters of credit, amounted to Php947 million. These commitments will expire within one year.

23. Provisions and Contingencies

We have made a reasonable estimate of the amount necessary to pay or settle the contested assessment in the event of an unfavorable judgment against us and have made the appropriate provisions in our unaudited consolidated financial statements as at June 30, 2005 aggregating Php5,854 million in respect of the following:

NTC supervision and regulation fees, or SRF

Since 1976, PLDT has received assessments from NTC for permit, SRF and other charges pursuant to Section 40 of Commonwealth Act 146, otherwise known as the Public Service Act. As at June 30, 2005, PLDT has paid, since 1994, a total amount of Php1,718 million in SRF, of which Php1,508 million was paid under protest.

PLDT is contesting the manner by which these assessments were calculated and the basis for such calculations. The case is now with the Supreme Court and upon the rules and practice of court, stands submitted for decision.

Smart and Piltel have similarly received assessments from NTC for permit, SRF and other charges which were paid under protest. Total payments amounted to Php122 million each in 2004 and 2003. Morever, on February 11, 2005, Piltel paid under protest the amount of Php559 million in respect of NTC fees for the period from 1992 to 2004.

Local business and franchise tax assessments

PLDT is presently a party to several cases involving the issue of exemption of PLDT from local franchise and business taxes. PLDT believes, based on the opinion of its legal counsel, that it is exempt from payment of local franchise and business taxes.

The Local Government Code of 1991, or R.A. No. 7160, which took effect on January 1, 1992, extended to local government units, or LGUs, power to tax businesses within their territorial jurisdiction granted under Batas Pambansa No. 337 and withdrew tax exemptions previously granted to franchise grantees under Section 12 of R.A. No. 7082.

PLDT believes, based on the opinion of its legal counsel, that R.A. No. 7925 which took effect on March 16, 1995, and the grant of local franchise and business taxes exemption privileges to other franchise holders subsequent to the effectivity of R.A. No. 7160, implicitly restored its local franchise and business taxes exemption privilege under Section 12 of R.A. No. 7082, or the PLDT Franchise pursuant to Section 23 thereof or the quality of treatment clause.

To confirm this position, PLDT sought and obtained on June 2, 1998 a ruling from the Bureau of Local Government Finance, or BLGF, of the Philippine Department of Finance, which ruled that PLDT is exempt from the payment of local franchise and business taxes imposable by LGUs under R.A. No. 7160.

By virtue of the BLGF Ruling, PLDT stopped paying local franchise and business taxes starting with the fourth quarter of 1998 and has filed with certain LGUs claims for tax refund covering the period from the second quarter of 1995 to the third quarter of 1998. PLDT has received assessments for local franchise and business tax from several cities and provinces following PLDT s decision to stop payment of local franchise and business taxes.

Following a decision of the Supreme Court on March 25, 2003, a judgment in the amount of Php4 million against PLDT involving the City of Davao became final and executory on April 9, 2003, pursuant to which PLDT was declared not exempt from the local franchise tax. Although PLDT believes that it is not liable to pay local franchise and business taxes, PLDT has entered into compromise settlements with several LGUs in order to maintain and preserve its good standing and relationship with these LGUs. Under these compromise settlements, which have been approved by the relevant courts, PLDT has paid a total amount of Php55 million as at June 30, 2005 for local franchise tax covering up to end of 2004.

PLDT continues to contest the remaining assessments amounting to Php3.7 million as at June 30, 2005, a number of which were based on the gross revenues of PLDT derived from its operations within the entire Philippines. PLDT claims that assuming that it is liable for local franchise tax, R.A. No. 7160 provides that local franchise tax shall be based on the gross receipts of the preceding year received or collected for services rendered within the jurisdiction of the taxing authority. Therefore, the use by some LGUs of gross revenues as the basis for computation of franchise tax is in gross violation of the law because it pertains to all income earned regardless of whether it was received or not, unlike gross receipts which are essentially the amount of money or its equivalent actually or constructively received. Moreover, gross revenues refer to all income earned by PLDT within and outside the jurisdiction of the local taxing authority; thus, the use thereof as a basis of computation will exceptionally overstate the franchise tax.

In a petition recently filed with the Supreme Court involving another LGU, PLDT has appealed to the Supreme Court for a re-examination of its decision in the City of Davao case in light of the strong dissenting opinion in that case concurred in by four other Justices of the Supreme Court. PLDT currently expects that going forward it will pay local franchise and business taxes on an annual basis and based on the gross receipts received or collected for services rendered within the jurisdiction of the respective taxing authority.

Smart has, likewise, received assessments for local franchise and business taxes from certain cities and provinces in the aggregate amount of Php313 million, which Smart continues to contest. Smart believes, based on the opinion of its legal counsel, that Smart is not liable to pay the local franchise and business taxes by virtue of (i) the opinion issued by the BLGF dated August 13, 1998; and (ii) Smart s exemption under its legislative franchise which took effect after the effective date of R.A. No. 7160.

Smart has recently been declared exempt from payment of local franchise tax to the City of Makati in a decision dated August 3, 2004 by the Regional Trial Court of Makati. The City of Makati has filed their motion for reconsideration and Smart has filed its opposition to that motion for reconsideration. The RTC of Makati has denied Makati s Motion for Reconsideration on November 12, 2004. They have filed a Motion for Extension to file a Petition for Review with the Court of Appeals. However, on June 9, 2005, the Court of Appeals has dismissed the appeal filed by the City of Makati.

The RTC of Iloilo has likewise ruled in a decision dated January 19, 2005 that Smart is exempt from payment of local franchise tax to the City of Iloilo. The City of Iloilo has filed an appeal directly with the Supreme Court but the Court has yet to give it due course.

Piltel s Bureau of Internal Revenue, or BIR, Assessment

Piltel received the following assessment notices from the BIR:

Year	**Tax Assessment Type**	**Basic**	**Interest**	**Total**
		(in million pesos)		
1998	Value Added Tax, or VAT	85.7	68.7	154.4
	Overseas Communications Tax	31.8	25.5	57.3
	Income Tax	12.4	9.4	21.8
	Administrative Penalties	0.1		0.1
1999	VAT	82.8	67.8	150.6
	Income Tax	17.8	13.8	31.6
2001	VAT	56.1	35.1	91.2
	Income Tax	13.4	8.9	22.3

Piltel filed applications for compromise settlement with the BIR for the deficiency tax assessments of 1998 and 1999, citing as basis for the compromise settlement its financial incapacity on account of networth and earnings deficit. Last June 22, 2005, however, Piltel received a letter from the BIR dated May 9, 2005 denying the applications for compromise settlements for the 1998 and 1999 tax assessments. Piltel intends to file a request for reconsideration with the BIR by presenting its latest audited and unaudited financial statements, which indicate that Piltel would still have networth and earnings deficit. If reconsidered, Piltel would be permitted to settle its deficiency tax liabilities by paying 10% to 40% of the assessed deficiency taxes.

Piltel filed last June 20, 2005 an administrative protest in connection with the 2001 tax assessment. Last July 1, 2005, Piltel received a tax verification notice, which granted a request for reinvestigation for the 2001 tax assessment. Piltel also intends to pursue an application for compromise settlement with the BIR once the reinvestigation is concluded and the tax assessment finalized.

Air Time Purchase Agreement with AIL

In March 1997, PLDT entered into a Founder NSP Air Time Purchase Agreement with PT Asia Cellular Satellite as amended in December 1998 and as assigned and transferred to AIL, under which PLDT was granted the exclusive right to sell ACeS services in the Philippines. The Air Time Purchase Agreement required PLDT to purchase from PT Asia Cellular Satellite at least US$5 million worth of air time annually over ten years, commencing on January 1, 2002, the date of commercial operations and has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term in the event revenues generated are less than US$45 million in any given year. The air time payment obligations shall remain in effect until all indebtedness incurred by AIL have been fully repaid. See *Note 20 Related Party Transactions* and *Note 22 Contractual Obligations and Commercial Commitments* for detailed discussion of the terms of the agreement.

PLDT and the other founder NSPs are endeavoring to amend the Air Time Purchase Agreement due to the occurrence of partial satellite loss, changes in the primary business of ACeS and other events affecting the business.

In March 2003, PLDT, together with the other founder NSPs, entered into a Standstill Agreement with AIL. Payments made to AIL under the Air Time Purchase Agreement based on billings of actual usage and the Standstill Agreement amounted to US$2 million and US$1 million for the second quarters of 2005 and 2004, respectively.

On February 10, 2004, notwithstanding the ongoing negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement effective January 1, 2002 following the lapse of the November 15, 2003 deadline set in the Standstill Agreement for the negotiation of a revised Air Time Purchase Agreement. As at June 30, 2005, PLDT s outstanding payables under the original Air Time Purchase Agreement was approximately Php4,068 million. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. Prior to further negotiation of definitive transaction agreement among the parties, PLDT deposited US$21.5 million in an escrow account on March 28, 2005 which was to be disbursed upon the execution and delivery of mutually agreeable definitive transaction agreement on or before April 29, 2005. The parties involved had not reached an agreement and on May 2, 2005, PLDT formally requested for the return of amount deposited which was returned on May 12, 2005.

On June 21, 2004, AIL also sent PLDT a letter citing PLDT in default under the Air Time Purchase Agreement for non-payment of outstanding amounts and for repudiation of its obligations thereunder. PLDT maintains, however, that the termination of the Standstill Agreement and reinstatement of the terms under the original Air Time Purchase Agreement are premature, considering that the discussions or negotiations on the terms of the proposed revised Air Time Purchase Agreement were still pending between the parties, such that it is highly inequitable for AIL to have unilaterally decided to invoke the provisions of the Standstill Agreement and declared PLDT in default. Furthermore, PLDT maintains its position that the Air Time Purchase Agreement has been rendered ineffective by various events, circumstances and technical problems encountered in the operation of the business of AIL. The substantial changes in the circumstances under which AIL must operate, changes which were not contemplated by the parties at the time the commitments were made, have rendered the commitments under the Air Time Purchase Agreement unrealistic and the performance of the same impossible.

As at June 30, 2005, PLDT s aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,857 million.

We made a reasonable estimate of the amount necessary in the event such obligation would be settled and have made the appropriate provisions in our unaudited consolidated financial statements as at June 30, 2005 with due consideration of AIL s existing indebtedness and of PLDT s share as one of the founder NSPs.

24. Financial Assets and Liabilities

Our financial assets and liabilities are recognized initially at fair value. Transaction costs (debt issuance costs) are included in the initial measurement of all financial assets and liabilities except for financial instruments measured at fair value through profit and loss. Subsequent to initial recognition, assets and liabilities are either valued at amortized cost using the effective interest rate method or at fair value depending on classification.

The following table sets forth the carrying values and estimated fair values of our financial assets and liabilities recognized as at June 30, 2005 and December 31, 2004. There are no material unrecognized financial assets and liabilities as at June 30, 2005 and December 31, 2004.

	Carrying Value		Fair Value	
	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)	**June 30, 2005 (Unaudited)**	December 31, 2004 (Audited)
	(in million pesos)			
Noncurrent Financial Assets				
Investments-available-for-sale	**109**	104	**109**	104
Derivative assets	**3,694**	4,116	**3,694**	4,116
Notes receivable	**346**	286	**346**	286
Total noncurrent financial assets	**4,149**	4,506	**4,149**	4,506
Current Financial Assets				
Cash and cash equivalents	**35,629**	27,321	**35,629**	27,321
Short-term investments	**27**	3,873	**27**	3,873
Trade and other receivables	**8,457**	10,404	**8,457**	10,404
Derivative assets	**217**	335	**217**	335
Total current financial assets	**44,330**	41,933	**44,330**	41,933
Total Financial Assets	**48,479**	46,439	**48,479**	46,439
Noncurrent Financial Liabilities				
Long-term debt - net of current portion*	**102,675**	121,012	**112,214**	132,803
Obligations under capital lease*	**516**	601	**516**	601
Preferred stock subject to mandatory redemption*	**13,611**	14,375	**16,994**	18,237
Derivative liabilities	**4,755**	5,903	**4,755**	5,903
Total noncurrent financial liabilities	**121,557**	141,891	**134,479**	157,544
Current Financial Liabilities				
Notes payable*	**56**	58	**56**	58
Current portion of long-term debt*	**28,880**	28,018	**29,614**	29,083
Obligations under capital lease*	**527**	425	**527**	425
Accounts payable	**5,300**	7,029	**5,300**	7,029
Derivative liabilities	**229**	474	**229**	474
Total current financial liabilities	**34,992**	36,004	**35,726**	37,069
Total Financial Liabilities	**156,549**	177,895	**170,205**	194,613

* *Included under Interest-bearing Financial Liabilities in the consolidated balance sheets.*

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate such value:

Interest-bearing Financial Liabilities:

Long-term debt: Fair value is based on the following:

Debt Type	Fair Value Assumptions
Fixed Rate Loans: U.S. dollar notes/convertible debt Other loans in all other currencies	 Quoted market price. Estimated fair value is based on the discounted value of future cash flows using the applicable rates for similar types of loans.
Variable Rate Loans	The carrying value approximates fair value because of recent and regular repricing based on market conditions.

Preferred stock subject to mandatory redemption: The fair values were determined using an independent third party valuation model.

Derivative instruments:

Forward foreign exchange contracts and bifurcated foreign currency forwards: The fair values were determined using forward exchange market rates at the balance sheet date.

Foreign currency options: The fair values were computed using an option pricing model.

Foreign currency and interest rate swaps: The fair values were computed as the present value of estimated future cash flows.

Due to the short-term nature of the transactions, the fair value of cash and cash equivalents, short-term investments, trade and other receivables, notes payable and accounts payable approximate amount of consideration at the time of initial recognition.

Financial assets and liabilities carried at amortized cost

Unamortized debt discount, representing debt issuance cost and any difference between the fair value of consideration given or received on initial recognition, included in following financial liabilities amounted to Php15,370 million and Php17,363 million as at June 30, 2005 and December 31, 2004, respectively, see *Note 17 Interest-bearing Financial Liabilities*.

Financial assets and liabilities carried at fair value

The following financial assets and liabilities carried at fair value as at June 30, 2005 and December 31, 2004.

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Investments-available-for-sale	**109**	104
Derivative instruments	**(1,073)**	(1,926)
	(964)	(1,822)

Derivative Financial Instruments

Our derivative financial instruments are accounted for as either cash flow hedges or transactions not designated as hedges. Cash flow hedges refer to those transactions that hedge our exposure to variability in cash flows attributable to a particular risk associated with a recognized asset or liability. Changes in the fair value of these instruments are recognized as cumulative translation adjustments in equity until the hedged item is recognized in earnings. For transactions that are not designated as hedges, any gains or losses arising from the changes in fair value are recognized directly to income for the period.

The table below sets out the information about our derivative financial instruments as at June 30, 2005 and December 31, 2004:

		June 30, 2005 (Unaudited)		December 31, 2004 (Audited)	
	Maturity	**Notional Amount**	**Mark-to-market Gain (Loss)**	Notional Amount	Mark-to-market Gain (Loss)
			(in millions)		
PLDT					
Cash flow hedges:					
Long-term currency swaps	2017	**US$300**	**Php624**	US$300	Php748

	2012	**250**	**(361)**	250	282
Long-term foreign currency options	2009	**175**	**915**	175	672
Short-term foreign currency options		**76**	**(156)**	76	(198)
Transactions not designated as hedges:					
Long-term foreign currency options		**175**(1)	**76**	175(1)	(22)
Short-term currency options		**88**(3)	**76**	76(2)	117
		JPY655	**(12)**	JPY	
Interest rate swap		**US$125**	**(2,315)**	US$125	(3,468)
Forward foreign exchange contracts		**87**	**92**	87	6
		JPY879	**(19)**	JPY14	1
Bifurcated embedded derivatives		**US$**		US$1	(1)
			(1,080)		(1,863)
Smart					
Transactions not designated as hedges:					
Forward foreign exchange contracts		**US$**	**(1)**	US$69	(77)
Bifurcated embedded derivatives		**9**	**8**	19	14
			7		(63)
Net liabilities			**(Php1,073)**		(Php1,926)

(1) Non-hedged portion of 2009 long-term foreign currency options based on the same notional amount as the hedged portion.

(2) Non-hedged portion of short-term foreign currency options based on the same notional amount as the hedged portion.

(3) Non-hedged portion of short-term foreign currency options is inclusive of the same notional amount as the hedged portion and additional short-term foreign currency options not designated as hedges.

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Presented as:		
Noncurrent assets	**3,694**	4,116
Current assets	**217**	335
Noncurrent liabilities	**(4,755)**	(5,903)
Current liabilities	**(229)**	(474)
Net liabilities	**(1,073)**	(1,926)

Cumulative translation adjustments as at June 30, 2005 and December 31, 2004 consists of:

	June 30, 2005 (Unaudited)	December 31, 2004 (Audited)
	(in million pesos)	
Cumulative translation adjustments beginning	**362**	549
Movements of cumulative translation adjustments:		
Currency translation differences	**(2)**	17
Net loss on cash flow hedges	**(867)**	(159)
Net gain (loss) on available-for-sale financial assets	**6**	(5)
Net gain (loss) on cash flow hedges removed from cumulative translation adjustments and taken to profit or loss	**131**	(133)
Deferred income tax effects on cash flow hedge	**236**	93
	(496)	(187)
Cumulative translation adjustments ending	**(134)**	362

Analysis of gain (loss) on derivative transactions for the six months ended June 30, 2005 and 2004 are as follows:

	Six Months Ended June 30,	
	2005	2004
	(Unaudited)	
Net mark-to-market loss ending	**(1,073)**	(1,664)
Net mark-to-market loss beginning	**(1,926)**	(1,060)
Net change	**853**	(604)
Net loss charged to cumulative translation adjustments	**867**	
Gain (loss) on contracts entered into and terminated during the period	**(533)**	99
Net gain (loss) on derivative transactions	**1,187**	(505)

PLDT

Cash Flow Hedges

Long-term Currency Swaps

PLDT entered into long-term principal-only currency swap agreements with various foreign counterparties to hedge the currency risk on its fixed rate notes maturing in 2009, 2012 and 2017. As at June 30, 2005 and December 31, 2004, these long-term currency swaps have an aggregate notional amount of US$550 million. Under the swaps, PLDT effectively exchanges the principal of its U.S. dollar-denominated fixed rate notes into peso-denominated loan exposures at agreed swap exchange rates. The agreed swap exchange rates are reset to the lowest U.S. dollar/Philippine peso spot exchange rate during the term of the swaps, subject to a minimum exchange rate. In March and April 2004, PLDT entered into amendments to keep the lowest reset exchange rate and unwind the downward resettable feature of US$550 million of its long-term principal-only currency swap agreements in order to lower the running hedging cost of the swaps. As at June 30, 2005 and December 31, 2004, the outstanding swap contracts have an agreed average swap exchange rate of Php50.76.

In order to manage hedge costs, these swaps included credit-linkage feature with PLDT as the reference entity. The specified credit events include bankruptcy, failure to pay, obligation acceleration, moratorium/repudiation, and restructuring of PLDT bonds or all or substantially all of PLDT s obligations. Upon the occurrence of any of these credit events, subject to agreed threshold amounts where applicable, the obligations to both PLDT and its counterparty under the swap contracts terminate without further settlements to either party, including any mark-to-market value of the swaps. In March 2004, PLDT amended an additional US$150 million of the long-term currency swaps to include this credit-linkage feature. As at June 30, 2005 and December 31, 2004, US$725 million of PLDT s long-term currency swaps/options have been structured to include credit-linkage with PLDT as the reference entity. The semi-annual fixed or floating swap cost payments that PLDT is required to make to its counterparties averaged about 3.79% and 2.95% per annum as at June 30, 2005 and December 31, 2004, respectively. As cash flow hedges, any movements in the fair value of these instruments will be taken as a cumulative translation adjustment under equity in our consolidated balance sheets.

Long-term Foreign Currency Options

To manage hedging costs, the currency swap agreement relating to the 2009 fixed rate notes has been structured to include currency option contracts. If the Philippine peso to U.S. dollar spot exchange rate on maturity date settles beyond Php90.00 to US$1.00, PLDT will have to purchase U.S. dollar at an exchange rate of Php52.50 to US$1.00 plus the excess above the agreed threshold rate. On the other hand, if on maturity, the Philippine peso to US$1.00 spot exchange rate is lower than the exchange rate of Php52.50 to US$1.00, PLDT will have the option to purchase at the prevailing Philippine peso to U.S. dollar spot exchange rate. In July 2004, PLDT and its counterparty, agreed to re-document and re-classify the transaction into long-term currency option contracts. The net semi-annual floating hedge cost payments that PLDT is required to pay under these transactions was approximately 4.72% and 3.94% per annum as at June 30, 2005 and December 31, 2004, respectively.

The option currency contract relating to PLDT s option to purchase U.S. dollar at Php52.50 to US$1.00 or prevailing spot rate at maturity whichever is lower, qualifies as a cash flow hedge. The option currency contract relating to the counterparty s option to purchase foreign currency from PLDT at Php90.00 to US$1.00 is not designated as a hedge. Please refer to discussion below (under transactions not designated as hedges).

Short-term Foreign Currency Options

PLDT utilized structures incorporating currency options to hedge the maturing principal on its fixed rate notes due June 2004 and August 2005. Under the terms of the contracts, PLDT will have the option to purchase U.S. dollar at an agreed Philippine peso to U.S. dollar spot exchange rate or prevailing spot rate at maturity whichever is lower.

Transactions Not Designated as Hedges

Due to the amounts of PLDT s foreign currency hedging requirements and the large interest differential between the Philippine peso and the U.S. dollar, the costs to book long-term hedges can be significant. In order to manage such hedging costs, PLDT utilizes structures that include currency option contracts, and fixed-to-floating coupon-only swaps that may not qualify for hedge accounting.

Long-term Foreign Currency Options

With reference to the above-mentioned hedge on the PLDT s 2009 fixed rate notes, PLDT simultaneously sold a currency option contract with the same notional amount of US$175 million with the same maturity that gives the counterparty a right to purchase foreign currency at Php90.00 to US$1.00. Together with the long-term currency option contract classified under cash flow hedges, PLDT has the obligation to purchase U.S. dollar at an exchange rate of Php52.50 to US$1.00 plus the excess above the agreed threshold rate. In exchange for this condition, the overall net hedging cost for the transaction is reduced.

Short-term Currency Options

In order to manage hedge costs, currency option contracts that hedge PLDT s fixed rate notes due June 2004 and August 2005 have features similar to that of the long-term currency option contracts. PLDT simultaneously sold currency option contracts with the same notional amounts with same maturity. Together with the other short term currency option contracts classified under cash flow hedges, PLDT has the obligation to buy U.S. dollar at the agreed strike price plus the excess above the agreed threshold rate should the Philippine peso to U.S. dollar spot exchange rate on maturity date settle beyond that agreed threshold. In exchange for this condition, the overall net hedging cost for the transactions is reduced.

PLDT also entered into short-term U.S. dollar subsidized forwards and Japanese yen currency option contracts to hedge other short-term foreign currency obligations.

Interest Rate Swap

A portion of PLDT s currency swap agreements to hedge its 2017 fixed rate notes carry fixed rate swap cost payments. To effectively lower the running cost of such swap agreements, PLDT, in April 2003, entered into an agreement to swap the coupon on US$125 million of its 2012 fixed rate notes into a floating rate Japanese yen amount. Under this agreement, PLDT is entitled to receive a fixed coupon rate of 11.375%, provided the Japanese yen to U.S. dollar exchange rate stays above JP¥99.90/US$1.00. Below this level, a reduced fixed coupon rate of 3% will be due to PLDT. In order to mitigate the risk of the Japanese yen strengthening below the agreed threshold, PLDT, in December 2003, entered into an overlay swap transaction to effectively lower the portion of the coupon indexed to the U.S. dollar to Japanese yen rate to 3%. Both swap agreements include a credit-linkage feature with PLDT as the reference entity.

Forward Foreign Exchange Contracts

PLDT entered into short-term U.S. dollar and Japanese yen forward foreign exchange contracts to hedge short-term foreign currency obligations.

Bifurcated Embedded Derivatives

Derivative instruments include derivatives (or derivative-like provisions) embedded in non-derivative contracts. PLDT s outstanding bifurcated embedded derivative transactions as at December 31, 2004 covered service contracts denominated in U.S. dollars paid out to a Japanese company in April 2005. There are no outstanding bifurcated embedded derivative transactions as at June 30, 2005.

Smart

Smart s embedded derivatives were bifurcated from service and purchase contracts. As at June 30, 2005 and December 31, 2004, outstanding contracts included a service contract with foreign equipment supplier and various suppliers covering handset and equipment importations payable in U.S. dollars.

Embedded derivatives were also bifurcated from prepaid forwards. The related prepayments amounting to Php27 million and Php3,873 million as at June 30, 2005 and December 31, 2004, respectively, are presented under Short-term investments. The embedded foreign currency derivatives bifurcated from these prepaid forwards are presented as derivative assets or derivative liabilities.

Financial Risk Management Objectives and Policies

The main purpose of our financial instruments is to fund our operations. We also enter into derivative transactions, the purpose of which is to manage the currency risks and interest rate risks arising from our operations and our sources of financing. It is, and has been throughout the year under review, our policy that no trading in financial instruments shall be undertaken.

The main risks arising from our financial instruments are liquidity risk, foreign currency risk, interest rate risk and credit risk. Our Board reviews and agrees with policies for managing each of these risks and they are summarized below. We also monitor the market price risk arising from all financial instruments. Our accounting policies in relation to derivatives are set out in *Note 2 Summary of Significant Accounting Policies*.

Liquidity Risk

We seek to manage our liquidity profile to be able to finance our capital expenditures and service our maturing debts. To cover our financing requirements, we intend to use internally generated funds and proceeds from debt and equity issues and sales of certain assets.

As part of our liquidity risk management program, we regularly evaluate our projected and actual cash flow information and continuously assess conditions in the financial markets for opportunities to pursue fund-raising initiatives. These initiatives may include bank loans, export credit agency-guaranteed facilities, and debt capital and equity market issues.

Foreign Currency Risk

The following table shows our consolidated foreign currency-denominated monetary assets and liabilities and their peso equivalents as at June 30, 2005 and December 31, 2004:

	June 30, 2005 (Unaudited)		December 31, 2004 (Audited)	
	U.S. Dollar	**Php Equivalent**(1)	U.S. Dollar	Php Equivalent(2)
	(in millions)			
Noncurrent Financial Assets				
Derivative assets	**US$61**	**Php3,435**	US$73	Php4,113
Notes receivable	**6**	**346**	5	286
Total noncurrent financial assets	**67**	**3,781**	78	4,399
Current Financial Assets				
Cash and cash equivalents	**315**	**17,668**	251	14,142
Short-term investments	**1**	**68**	69	3,888
Trade and other receivables	**141**	**7,938**	146	8,226
Derivative assets	**21**	**476**	6	338
Total current financial assets	**478**	**26,150**	472	26,594
Total Financial Assets	**US$545**	**Php29,931**	US$550	Php30,993
Noncurrent Financial Liabilities				
Interest-bearing financial liabilities	**US$2,022**	**Php113,578**	US$2,330	Php131,275
Derivative liabilities	**85**	**4,755**	105	5,916
Total noncurrent financial liabilities	**2,107**	**118,333**	2,435	137,191
Current Financial Liabilities				
Accounts payable	**20**	**1,124**	46	2,592
Accrued expenses and other current liabilities	**54**	**3,017**	77	4,338
Derivative liabilities	**4**	**229**	8	451
Interest-bearing financial liabilities	**511**	**28,644**	483	27,213
Total current financial liabilities	**589**	**33,014**	614	34,594
Total Financial Liabilities	**US$2,696**	**Php151,347**	US$3,049	Php171,785

(1) The exchange rate used was Php56.177 to US$1.00.

(2) The exchange rate used was Php56.341 to US$1.00.

In translating the foreign currency-denominated monetary assets and liabilities into peso amounts, the exchange rates used were Php56.177 to US$1.00 and Php56.341 to US$1.00, the Philippine peso-U.S. dollar exchange rates as at June 30, 2005 and December 31, 2004, respectively.

As at August 3, 2005, the peso dollar exchange rate was Php56.106 to US$1.00. Using this exchange rate, our consolidated net foreign currency denominated liabilities as at June 30, 2005 would have decreased by Php153 million.

While a certain percentage of our revenues is either linked to or denominated in U.S. dollars, substantially all of our indebtedness and related interest expense, a substantial portion of our capital expenditures and a portion of our operating expenses are denominated in foreign currencies, mostly in U.S. dollars.

As at June 30, 2005, approximately 98% of our total consolidated debts were denominated in foreign currencies principally in U.S. dollars. Of our foreign currency-denominated debts, 4% are in Japanese yen and the balance in U.S. dollars. Thus, a weakening of the Philippine peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 62% of our consolidated foreign-currency debts), and interest expense on our debt in peso terms. In addition, many of our financial ratios and other financial tests will be negatively affected. If, among other things, the value of the Philippine peso against the U.S. dollar substantially drops from its current level, we may be unable to maintain compliance with these ratios, which could result in acceleration of some or all of our indebtedness. For further information on our loan covenants, see *Note 17 Interest-bearing Financial Liabilities*.

To manage our foreign exchange risks, stabilize cash flows, and improve investment and cash flow planning, we enter into foreign exchange forward contracts, foreign currency swap contracts, currency options and other hedging products aimed at reducing and/or managing the adverse impact of changes in foreign exchange rates on our operating results and cash flows. However, these hedges do not cover all of our exposure to foreign exchange risks.

Specifically, we use forward foreign exchange contracts, foreign currency swap contracts and currency option contracts to manage the foreign exchange risk associated with our foreign currency-denominated loans.

Interest Rate Risk

On a limited basis, we enter into interest rate swap agreements in order to manage our exposure to interest rate fluctuations. We make use of hedging instruments and structures solely for reducing or managing financial risks associated with our liabilities and not for trading or speculative purposes.

The following tables set out the carrying amount, by maturity, of our financial instruments that are exposed to interest rate risk:

Six Months Ended June 30, 2005 (Unaudited)

	Discount/ Debt

	Below 1 year	1-2 years	2 3 years	3-5 years	Over 5 years	In U.S. Dollar	In Php	Issuance Cost In Php	Carrying Value In Php	Fair Value In U.S. Dollar	Fair Value In Php
									(in millions)		
Liabilities:											
Long-term Debt											
Fixed Rate											
US$ Notes (in millions)	230	236		175	550	1,191	66,879	837	66,042	1,293	72,650
Interest rate	9.25% to 9.875%	7.85% to 10.625%		10.50%	8.35% to 11.375%						
US$ Fixed Loans (in millions)	101	52	42	39	280	514	28,861	7,000	21,861	414	23,193
Interest rate	4.49% to 7.95%	4.49% to 7.95%	4.49% to 7.58%	4.49% to 6.66%	2.25%						
Japanese Yen (in millions)	25	25	25			75	4,238		4,237	76	4,280
Interest rate	2.125%	2.125%	2.125%								
Philippine Peso (in millions)	6	14		14		34	1,926	5	1,921	38	2,141
Interest rate	11.18% to 24%	15.816% to 24%		15.00%							
Variable Rate											
U.S. Dollar (in millions)	149	160	115	147	104	675	37,917	1,958	35,959	675	37,917
Interest rate	GOVCO s Cost + 0.20%; 0.15% to 4.30% over LIBOR	GOVCO s Cost + 0.20%; 0.15% to 4.30% over LIBOR	GOVCO s Cost + 0.20%; 0.15% to 4.30% over LIBOR	0.15% to 2.50% over LIBOR	0.5% to 2.5% over LIBOR						
Japanese Yen (in millions)	6	6	5			17	958	2	956	17	958
Interest rate	1.70% over LIBOR	1.70% over LIBOR	1.70% over LIBOR								
Philippine Peso (in millions)		2	2	1	7	12	689	111	578	12	689
Interest rate											

	1% over 91-day T-bill rate; 11% to 11.25%	1% over 91-day T-bill rate; 11% to 11.25%	1% over 91-day T-bill rate; 11% to 11.25%	1% over 91-day T-bill rate	1% over 91-day T-bill rate						
						2,518	**141,468**	**9,913**	**131,555**	**2,525**	**141,828**
Interest rate swap (fixed to floating)											
U.S. Dollar (US$125 million)						(41)	(2,315)				
Japanese Yen (JPY15,037 million)										(41)	(2,315)
Fixed Rate on US$ notional	11.375%	11.375%	11.375%	11.375%	11.375%						
Variable Rate on JPY notional	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR						

Year Ended December 31, 2004 (Audited)

	Below 1 year	**1-2 years**	**2-3 years**	**3-5 years**	**Over 5 years**	**In U.S. Dollar**	**In Php**	**Discount/ Debt Issuance Cost In Php**	**Carrying Value In Php (in millions)**	**Fair Value In U.S. Dollar**	**Fair Value In Php**
Liabilities:											
Long-term Debt											
Fixed Rate											
US$ Notes (in millions)	110	130	272	175	550	1,237	69,725	930	68,795	1,307	73,662
Interest rate	9.875%	9.250%	7.85% to 10.625%	10.50%	8.35% to 11.375%						
US$ Fixed Loans (in millions)	125	93	51	58	280	607	34,190	7,340	26,850	576	32,452

Interest rate	4.49% to 8.03%	4.49% to 7.95%	4.49% to 7.95%	4.49% to 7.58%	2.25%						
Japanese Yen (in millions)	27	27	27	14		95	5,363		5,363	96	5,414
Interest rate	2.125%	2.125%	2.125%	2.125%							
Philippine Peso (in millions)	14	14			14	42	2,371	5	2,366	45	2,537
Interest rate	11.18% to 24%	11.6% to 24%			15%						
Variable Rate											
U.S. Dollar (in millions)	212	213	139	117	132	813	45,832	2,045	43,787	814	45,832
Interest rate	0.15% to 4.3% over LIBOR	0.15% to 4.3% over LIBOR	0.15% to 4.3% over LIBOR	0.15% to 4.3% over LIBOR	0.5% to 2.5% over LIBOR						
Japanese Yen (in millions)	6	6	6	4		22	1,212		1,212	22	1,212
Interest rate	1.7% over JPY LIBOR	1.7% over JPY LIBOR	1.7% over JPY LIBOR	1.7% over JPY LIBOR							
Philippine Peso (in millions)	2	2	2	1	7	14	777	120	657	13	777
Interest rate	1.0% over 91-day T-bill rate; 11% to 11.25%	1.0% over 91-day T-bill rate; 11% to 11.25%	1% over 91-day T-bill rate; 11% to 11.25%	1% over 91-day T-bill rate	1% over 91-day T-bill rate						
						2,830	**159,470**	**10,440**	**149,030**	**2,873**	**161,886**
Interest rate swap (fixed to floating)											
U.S. Dollar (US$125 million)						(62)	(3,468)			(62)	(3,468)
Fixed Rate on US$ notional	11.375%	11.375%	11.375%	11.375%	11.375%						

Variable Rate on JPY notional	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR	8.11% over LIBOR

Fixed rate financial instruments are subject to fair value interest rate risk while floating rate financial instruments are subject to cash flow interest rate risk.

Repricing of floating rate financial instruments is mostly done on intervals of three months or six months. Interest on fixed rate financial instruments is fixed until maturity of instrument. Financial instruments that are not subject to interest rate risk were not included in the above tables.

Credit Risk

We trade only with recognized, creditworthy third parties. It is our policy that all customers who wish to trade on credit terms are subject to credit verification procedures. In addition, receivable balances are monitored on an ongoing basis to reduce our exposure to bad debts.

With respect to credit risk arising from our other financial assets, which comprise cash and cash equivalents, certain derivative instruments, our exposure to credit risk arises from default of the counterparty, with a maximum exposure equal to the carrying amount of these instruments.

We have no significant concentrations of credit risk.

25. Other Matters

a. Interconnection Agreements

PLDT has existing interconnection agreements with nine International Gateway Facilities, or IGF operators, six Inter Exchange Carriers, or IXCs, six Cellular Mobile Telephone Systems, or CMTS operators, 70 LECs (including members of the Philippine Association of Private Telephone Companies, Inc.), and 12 paging and trunk radio operators. These interconnection agreements include provisions for settlement and payment of charges. Settlements with interconnecting IGF operators and CMTS operators for local calls are in the form of access charges. Settlement with interconnecting IXCs and LECs for toll calls are based on hauling and access charges, and to some extent, revenue sharing. Settlement also involves payment of access charges, but settlement for toll calls is on a revenue-sharing basis. LEC to LEC interconnection with hauling from one service area to another service area is settled based on trunk charges, while overlay LEC to LEC interconnection in a given service area is without charges. Paging and trunk radio interconnection settlements are based on fixed charges.

b. U.S. Federal Communications Commission, or U.S. FCC, Ruling versus Philippine Telecommunications Companies

Effective as at February 1, 2003, PLDT stopped terminating traffic sent directly by each of AT&T and MCI, because PLDT s termination rate agreements with AT&T and MCI lapsed in December 2002 without either agreeing with PLDT on any provisional arrangement or final agreement on new termination rates. In separate orders dated February 7 and 26, 2003, the NTC confirmed that absent any provisional or interim agreement with U.S. carriers, there would be no provision of termination services between the parties who are thereby encouraged to seek other routes or options to terminate traffic to the Philippines. Upon petitions of AT&T and MCI, on March 10, 2003, the International Bureau of the U.S. FCC issued an Order which directed all facilities-based carriers subject to U.S. FCC jurisdiction to suspend payments for termination services to Philippine carriers, including PLDT, Smart and Subic Telecom, until such time as the U.S. FCC issued a Public Notice that AT&T s and MCI s circuits on the U.S. Philippine route were fully restored. The Order also removed the Philippines from the list of U.S. international routes approved for the provision of International Simple Resale, or ISR. In response to the International Bureau s Order, the NTC issued a Memorandum Order dated March 12, 2003, directing all affected Philippine carriers (1) not to accept terminating traffic via direct circuits from U.S. facilities-based carriers who do not pay Philippine carriers for services rendered; and (2) to take all measures necessary to collect payments for services rendered in order to preserve the viability, efficiency, sustained growth and development and continued competitiveness of the Philippine telecommunications industry.

On October 17, 2003, based on negotiations between the NTC and the U.S. FCC to resolve the issue regarding termination rates, the NTC, in the expectation that the U.S. FCC would fully lift the March 10, 2003 Order, lifted its March 12, 2003 Order and directed all Philippine carriers to immediately accept terminating traffic via direct circuits from U.S. facilities-based carriers at mutually acceptable final or interim termination rates and other terms and conditions agreed upon by the parties.

On November 17, 2003, after Smart reached interim agreements with each of AT&T and MCI on September 30 and November 12, 2003, respectively, the International Bureau of the U.S. FCC lifted its March 10, 2003 Order with respect to Smart and ordered the U.S. carriers to resume making payments to Smart.

On January 15, 2004, after PLDT reached interim agreements with each of MCI and AT&T and reopened its circuits with these carriers on November 12, 2003 and January 9, 2004, respectively, the International Bureau of the U.S. FCC lifted its March 10, 2003 Order also with respect to PLDT and ordered the U.S. carriers to resume making payments to PLDT.

On May 13, 2004, the U.S. FCC partially dismissed and partially denied applications by Philippine carriers, including PLDT, and certain U.S. carriers for review of the March 10, 2003 Order of the International Bureau of the U.S. FCC. In particular, the U.S. FCC affirmed the March 10, 2003 Order s finding that Philippine carriers engaged in collective action to whipsaw AT&T and MCI. The U.S. FCC stated, however, that the findings of the March 10, 2003 Order were not findings under the U.S. anti-trust laws and that the U.S. Department of Justice is independently investigating the possibility of anticompetitive practices among Philippine carriers under its authority pursuant to U.S. anti-trust laws. The U.S. FCC also upheld the March 10, 2003 Order in respect of the suspension of payments for termination services to the Philippine carriers pending restoration of the circuits. In addition, the U.S. FCC denied a request to modify the March 10, 2003 Order of the International Bureau of the U.S. FCC to restore the Philippines to the list of U.S.-international routes approved for the provision of ISR. The U.S. FCC stated that it was dismissing this request as moot because of the U.S. FCC s recently adopted International Settlements Policy Reform Order which eliminated ISR policies.

Although not included in the initial list of countries exempted from the U.S. FCC s International Settlements Policy, or ISP, the U.S. FCC identified the U.S. Philippines route as eligible for being removed from the ISP in accordance with its newly established procedures for doing so. Under this procedure, the U.S. FCC asked for public comment on the removal of the Philippines from the ISP. In comments filed in June and July 2004, removal was reported by several Philippine and U.S. carriers, including AT&T and MCI, and was opposed by one U.S. carrier, International Access, Inc. In November 2004, the U.S. FCC exempted a number of additional countries from the ISP, but not the Philippines. Instead, the U.S. FCC stated that it would rule separately regarding the Philippines after reviewing the issues raised by International Access, Inc. These issues are still pending before the U.S. FCC.

On July 6, 2004, PLDT filed with the U.S. FCC a petition for reconsideration of the U.S. FCC s May 13, 2004 Order on the grounds that the order should have vacated as moot the International Bureau s March 10, 2003 Order.

c. Investigation by the U.S. Department of Justice

In January 2004, PLDT received a grand jury subpoena seeking documents and a PLDT employee was subpoenaed to testify before the grand jury in connection with a criminal investigation being conducted by the U.S. Department of Justice with respect to alleged anti-trust violations relating to the provision of international termination services in the Philippines. The U.S. Department of Justice has also requested testimony and documents from Smart in connection with this investigation. Further, in March 2004, PLDT (U.S.) Ltd., a subsidiary of PLDT Global, received a grand jury subpoena seeking documents, in response to which PLDT (U.S.) Ltd. produced documents. In February 2005, two former employees of PLDT U.S. Ltd. testified before the grand jury in the U.S. Department of Justice matter. A PLDT employee was also scheduled to reappear for testimony in February, but his appearance has been postponed. On May 11, 2005, the U.S. Department of Justice informed our legal counsel in Washington, D.C., Covington & Burling, that the U.S. Department of Justice has terminated its antitrust investigation relating to termination rate increases implemented in early 2003 by certain Philippine long distance carriers including PLDT and that no enforcement action will be taken.